Drafting Delaware Trusts

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Drafting Delaware Trusts

- Wealth Enhancement with Dynasty Trusts
- Directed Trusts with Third-Party Advisers
- Favorable Income Tax Laws
- Asset Protection Trusts
- Freedom of Disposition
  - Privacy and Confidentiality
  - Pre-Mortem Validation
- Moving Trusts to Delaware

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Wealth Enhancement with Dynasty Trusts

- Gifts to grantor trusts – Client transfers up to $5 MM to trust, pays trust's income taxes, reducing taxable estate.
- Gifts and sales to grantor trusts – Client transfers seed money in reliance on $5 million exemption; client sells appreciating asset to trust in return for a note with interest at AFR.
- Drafting Consideration

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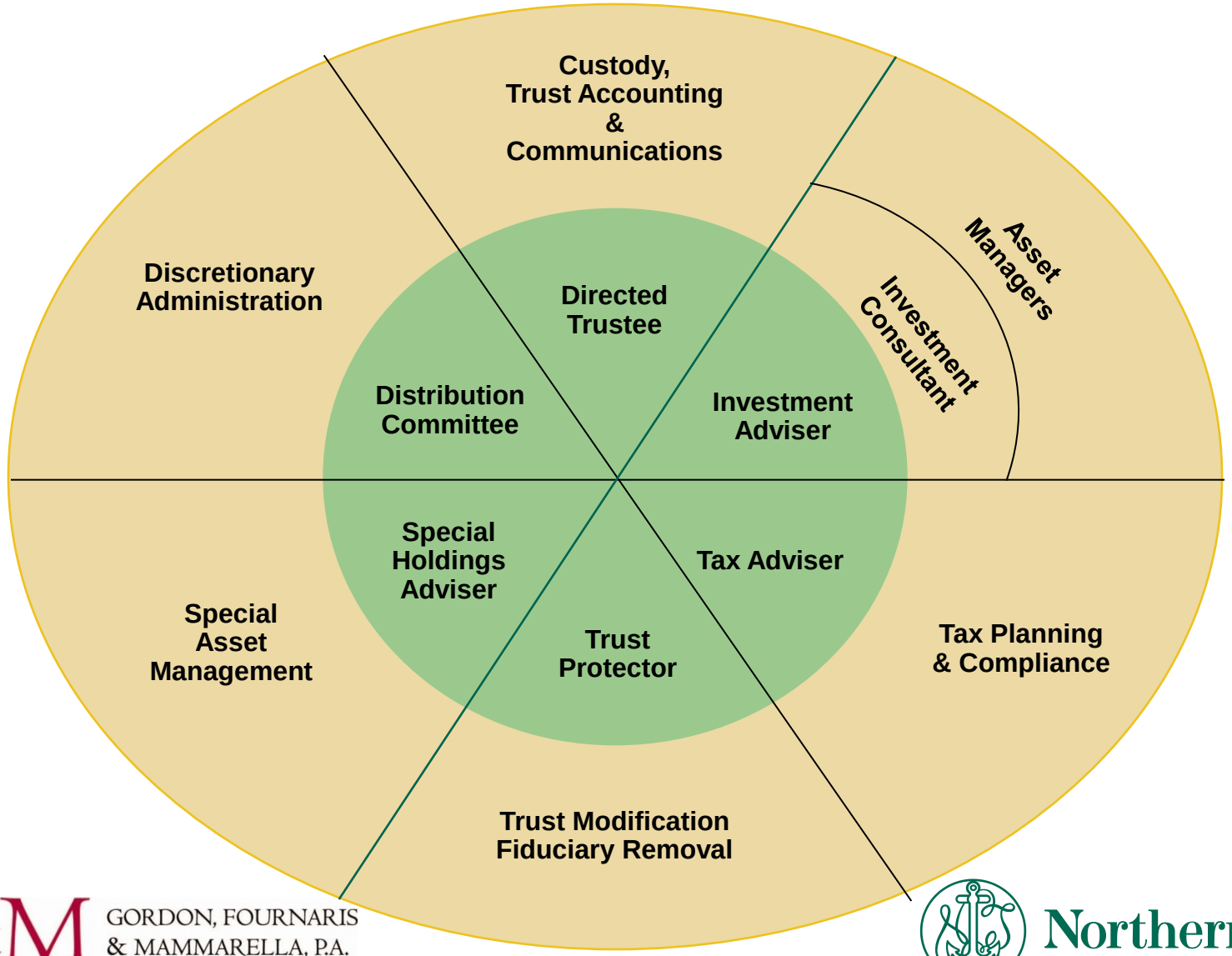
The Directed Trust as an Enterprise Trust



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Directed Trusts

- Since 1986 Delaware law has allowed trustees to take direction from advisers with limited liability.
- Trustee Liability
  - Directed trustees are exonerated except for willful misconduct (12 Del. C. § 3303(a), 3313(b)).
  - Drafting Consideration
- Adviser liability
  - Advisers are fiduciaries by default under Delaware law, unless the governing instrument provides otherwise.
  - The instrument may exonerate and indemnify advisers, except for willful misconduct
  - Drafting Consideration

Client Suitability

- Investment Advisers
  - Grantors who want to fund a trust with interests in closely-held entities and want to maintain control over the management of such entities.
  - Trusts that contain a concentrated position that has historical value to the family.
  - Drafting Consideration
- Distribution Advisers
  - May be useful if grantor imposes “productivity”, “lifestyle” standards or other subjective criteria for a beneficiary’s entitlement to distributions
  - Distribution Advisers can direct the Trustee to decant the assets of the trust into a new trust
  - Drafting Consideration

Client Suitability

- Trust Protectors
  - to improve the trust's administration
  - to modify a power of appointment or to give a beneficiary a power of appointment
  - To transfer situs and law governing administration
  - To converting a trust from a grantor trust to a non-grantor trust
  - To have investment responsibility for certain assets

Favorable Income Tax Laws

- The Delaware Statute
  - Delaware does not tax that portion of trust income and capital gains accumulated and set aside for future distribution to non-resident beneficiaries. 30 Del. C. § 1636(a).
  - If all of the beneficiaries of the Delaware trust are non-residents, the trust pays no Delaware State income tax.
  - Many non-resident trusts (including many from Massachusetts) have been moved to Delaware to avoid state income tax that would otherwise apply.
- State income tax considerations
  - Residence of Grantor at the time the trust was created.
  - Residence of fiduciaries.
  - Residence of trust beneficiaries.

Asset Protection Trusts

- In 1997 Delaware became the second state to permit an “asset protection” trust.
- Currently, at least 14 states permit asset protection trusts in some fashion: Delaware, Alaska, Rhode Island, Nevada, Utah, Missouri, Oklahoma, South Dakota, Tennessee, Wyoming, New Hampshire, Hawaii, Virginia and Ohio (effective March 2013).
- With a properly structured Delaware asset protection trust, the grantor may be a beneficiary of the trust and retain certain powers over the trust.

Asset Protection Trusts

- A creditor of the grantor will not be able to reach the trust assets unless its claim is filed within the applicable tail period and it establishes that the funding of the trust was a fraudulent transfer.
- A "future creditor" can prevail only by showing, with clear and convincing evidence, that the grantor actually intended to defraud *that particular creditor* by making a transfer of assets to the trust.
- The creditor must assert its claim against the trust within a "tail period" of four years from the funding of the trust.
- Two classes of claims are not subject to the tail period or the need to prove a fraudulent transfer:
  - A spouse or child with claims for alimony, support or a share of marital property in connection with a divorce or separation proceeding *(a "spouse" does not include one who marries the grantor <u>after</u> the transfer.)*
  - Claims for death, personal injury or property damage precede the funding of the trust.

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Asset Protection Trusts – Powers a Grantor May Retain

- Veto distributions from the trust
- Limited power of appointment effective on grantor's death
- Potential or actual receipt of income
- Potential or actual receipt of principal if distribution is result of trustee or distribution adviser acting
  - In trustee's or distribution adviser's sole discretion, or
  - Pursuant to a standard that does not confer on the grantor a substantially unfettered right to principal
- The right to remove a trustee or adviser and appoint a new trustee or adviser
- The right to serve as the investment adviser for the trust

Asset Protection Trusts – Powers a Grantor May Not Retain

- The power to serve as trustee of the trust
- The power to serve as a distribution adviser for the trust
- The power to serve as the trust protector for the trust
- The power to direct distributions from the trust
- The power to demand a return of assets transferred to the trust
  - Drafting Consideration

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Types of Asset Protection Trusts - Incomplete Gift Grantor Trusts

- The transfer into the trust is an incomplete gift for gift tax purposes by virtue of the grantor's retention of a testamentary limited power of appointment and a veto power. Treas. Reg. § 25.2511-2(b).
- The trust is a grantor trust for income tax purposes under Section 677(a)(1) of the Internal Revenue Code as the trustee can distribute income to the grantor without the consent of an adverse party.
- Clients utilizing this type of asset protection trust are purely concerned with asset protection and are not using the trust for any type of tax planning.
    - Drafting Consideration

Types of Asset Protection Trusts - Incomplete Gift Non-Grantor Trusts

- It is possible for a grantor to establish a trust in a jurisdiction that allows for the creation of self-settled asset protection trusts, retain a beneficial interest in the trust and have the trust treated as a non-grantor trust for income tax purposes.
- In Delaware we refer to these trusts as DING trusts. The acronym stands for Delaware Incomplete Gift Non-Grantor trusts.
- Section 677(a)(1) of the Internal Revenue Code provides that a Grantor will be treated as the owner of a trust for income tax purposes if trust income, without the approval or consent of any adverse party, may be distributed to the grantor or the grantor's spouse. Therefore, in order for the trust to be a non-grantor trust for income tax purposes, the consent of an adverse party must be obtained prior to distributing assets to the grantor or the grantor's spouse.

Types of Asset Protection Trusts - Incomplete Gift Non-Grantor Trusts

- The trust also must be created in a jurisdiction which allows for self-settled asset protection trusts because if creditors of the grantor can reach the trust assets the trust will be a grantor trust for income tax purposes. Treas. Reg. § 1.677(a)-1(d).
- The trust is structured as an incomplete gift for federal gift tax purposes through the grantor's retention of a testamentary limited power of appointment over the trust. Treas. Reg. § 25.2511-2(b).
- Several Private Letter Rulings confirm that under Delaware law a grantor can create a non-grantor trust, fund the trust with contributions that are not considered taxable gifts for federal gift tax purposes and still retain the right to receive discretionary distributions of trust income and principal from the trust. See PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; and PLR 200502014.
- Drafting considerations

Types of Asset Protection Trusts - Incomplete Gift Non-Grantor Trusts

Concerns over DING structure

- In 2007 the IRS issued a notice calling into question the gift tax consequences to the members of the Distribution Committee. IR-2007-127.
- The notice stated that the conclusions reached in the PLRs with respect to the gift tax consequences of the Distribution Committee members may not be consistent with Revenue Ruling 76-503 and Revenue Ruling 77-158.
- CCA 201208026 has called into question whether the mere retention by the grantor of a testamentary limited power of appointment is sufficient to cause the transfer of assets to a trust to be an incomplete gift for gift tax purposes.

Completed Gift Asset Protection Trust

- It is possible for a grantor to establish a trust in a jurisdiction that allows for the creation of self-settled asset protection trusts, transfer assets to the trust to which the grantor allocates gift tax exemption, retain a discretionary beneficial interest in the trust and have the assets excluded from the grantor's estate for federal estate tax purposes.
- In order for a grantor to cause a transfer to the trust to be a completed gift for gift tax purposes the grantor must part with dominion and control over the property. Treas. Reg. § 25.2511-2(b).
- If an individual creates a self-settled trust in a jurisdiction where his or her creditors may attach the assets, the grantor has retained sufficient dominion and control over the assets because under local law the grantor is able to relegate his or her creditors to the assets of the trust. See Rev. Rul. 76-103; Rev. Rul. 77-378; and Paolozzi v. Commissioner, 23 T.C. 102 (1954). As such, the trust must be established in a jurisdiction that allows for self-settled asset protection trusts thereby preventing the grantor from being able to relegate his or her creditors to the assets of the trust.
- Drafting consideration: As opposed to naming the grantor as a discretionary beneficiary of the trust from the outset, consider giving the Trust Protector the power, exercisable in a non-fiduciary capacity, to expand the permissible class of beneficiaries.

Completed Gift Asset Protection Trust

Revenue Ruling and PLRs

- Revenue Ruling 2004-64 addressed the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor of a trust may or must be reimbursed by the trust for the income tax liability associated with the trust's income being includable in the grantor's gross income.
- Revenue Ruling 2004-64 held that assuming there is no understanding, expressed or implied, between the grantor and the trustee regarding the trustee's exercise of its discretion to reimburse the grantor for the income tax liability, the trustee's discretion to satisfy such obligation will not alone cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.
- However, Revenue Ruling 2004-64 specifically stated that the trustee's discretion to reimburse the grantor for income tax liability combined with other factors including, but not limited to: (i) an understanding or preexisting arrangement between the grantor and the trustee regarding the trustee's exercise of its discretion; (ii) a power retained by the grantor to remove the trustee and name a successor trustee; or (iii) applicable local law subjecting the trust assets to claims of the grantor's creditors may cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.
- Two Private Letter Rulings have been issued addressing the transfer tax consequences associated with self-settled asset protection trusts. See PLR 9837007 and PLR 200944002. Both Private Letter Rulings involve the use of Alaska trusts established by Alaska residents.

Completed Gift to Asset Protection Trust

Creditor Exceptions and Acts of Independent Significance

- All states that have self-settled trust legislation, other than Alaska and Nevada, allow certain creditors to access the trust.
- A question has arisen as to whether the mere fact that a family creditor can reach the trust assets is enough to cause the transfer to the trust from being an incomplete gift or otherwise cause the trust assets to be included in the grantor's gross estate under Sections 2036(a)(2) and 2038 of the Internal Revenue Code.
- Proponents of Alaska and Nevada law have argued that the mere existence of the family claim exception contained in statutes of other jurisdictions, such as Delaware, would be enough to cause the assets to be includable in the grantor's estate under Sections 2036(a)(2) and 2038 of the Internal Revenue Code and therefore a grantor should only establish a trust in Alaska or Nevada if the grantor desires for the trust assets to be excluded from his or her estate.

Completed Gift to Asset Protection Trust

Creditor Exceptions and Acts of Independent Significance

- What is overlooked in this argument is the theory of acts of independent significance. The theory of acts of independent significance is applied when determining whether the grantor retained a power which arises to the level of a power which would cause inclusion in the grantor's gross estate under Sections 2036(a)(2) or 2038 of the Internal Revenue Code or otherwise result in an incomplete gift. If the retained power allows the grantor the ability to act in such a way so as to affect the beneficial interest of the trust, but the possibility of such action occurring is so diminimus and speculative, the power will be found to be an act of independent significance. See Estate of Tulley, 528 F.2d 1401 (1976); Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; Rev. Rul. 80-255; and PLR 9141027.
- Courts have ruled that the possibility of divorce is an act of independent significance. See Estate of Tulley, 528 F.2d 1401; PLR 9141027.
- Courts have also determined that acts of independent significance include failure to support a spouse as well as the ability to have or adopt children. Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; and Rev. Rul. 80-255.

Freedom of Disposition: Privacy and Confidentiality

- Delaware trusts are not subject to any public registration or filing requirements.
- Delaware law permits a trustee to withhold knowledge of a trust's existence from beneficiaries for a period of time if the governing instrument directs . 12 Del. C. § 3303(a).
  - Drafting Consideration
- Use of Designated Representative

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Freedom of Disposition: Pre-Mortem Validation

- Delaware law permits a trustee to give a person notice of the creation of a trust. The notice starts a 120-day period to contest the validity of the trust.
- 12 Del. C. § 3546(a)(1) requires the notice to specify: the fact of the trust's existence, the name of the trustee, whether the person is a beneficiary, and the time allowed for initiating a proceeding to contest the validity of the trust.
- The effect of the notice statute is to compel a dissenting person to mount a challenge to the validity of the trust while the grantor is still living.
- Examples

Moving Trusts to Delaware

- Reformation
  - Court Involvement
  - Beneficiary Consent
- Decanting
  - Necessary Provisions
  - Trustee Liability

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