DELAWARE ASSET PROTECTION TRUSTS AND STATE INCOME TAXATION OF TRUSTS

A Presentation For The
Delaware Bankers Association 2006 Delaware Trust Conference

Todd A. Flubacher, Esq.
Morris, Nichols, Arsht & Tunnell LLP
November 29, 2006

IRS Circular 230

To ensure compliance with IRS requirements, I must inform you that any U.S. federal tax advice contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code or for the purpose of promoting, marketing, or recommending any transaction or matter addressed herein.

History of Asset Protection Trusts

- Third party spendthrift trusts
- Offshore trusts
- Alaska and Delaware enacted the first two statutes in the United States in 1997
- Delaware Qualified Dispositions in Trust Act, 12 Del. C. §§ 3570-76

Asset Protection Trusts In A Nutshell

- An asset protection trust is essentially a trust where the trust instrument contains a spendthrift provision that is enforceable with respect to the settlor's beneficial interests in the trust.

REQUIREMENTS FOR SETTING UP A DELAWARE ASSET PROTECTION TRUST

Qualified Disposition to a Qualified Trustee

- A "qualified disposition" means a disposition by or from a transferor to a qualified trustee, with or without consideration, by means of a trust instrument.
- The "qualified trustee" must be either a Delaware resident individual (other than the transferor) or an entity (i) authorized by Delaware law to act as a trustee and (ii) subject to supervision by the Delaware Bank Commissioner, the FDIC, the OCC or the Office of Thrift Supervision.

Requirements of Trust Instrument

Generally, the trust instrument of a Delaware asset protection trust must satisfy the following conditions:

- Appoints a qualified trustee or qualified trustees
- Incorporates Delaware law to govern the validity, construction and administration of the Trust
- Must be irrevocable
- Must contain a provision that provides that the interest of the transferor or other beneficiary in the trust property or the income therefrom may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before the qualified trustee or qualified trustees actually distribute the property or income therefrom to the beneficiary and such provision shall be deemed to be a restriction on the transfer of the transferor's beneficial interest that is enforceable under applicable nonbankruptcy law within the meaning of Sec. 541(c)(2) of the Bankruptcy Code
- May not provide the transferor with any interest in the trust estate other than those retained interests specifically enumerated
- Must meet trust validity requirements under Delaware law

Nexus of Trust To Delaware

The trustee must perform one or more of the following functions within the State of Delaware:

- Maintain or arrange for custody in Delaware of some or all of the trust property;
- Maintain records for the trust on an exclusive or nonexclusive basis;
- Prepare or arrange for the preparation of fiduciary income tax returns; or
- Otherwise materially participate in the administration of the trust.
- The Trusts may have non-Delaware co-trustees, investment advisers, trust protectors, distribution advisers and other advisers located outside Delaware.
- BEWARE: Situs and Choice of Law Rules!

Settlor's Permissible Retained Powers

Generally, the settlor of a Delaware asset protection trust may retain one or more of the following rights and powers:

- The potential or actual receipt of income in the sole discretion of the trustee
- The right to receive the trust's income
- The potential or actual receipt of income or principal from a charitable remainder unitrust or a charitable remainder annuity trust, as defined in § 664 of the Internal Revenue Code
- The right to receive a specified percentage or dollar amount not in excess of 5% of the value of the trust property each year
- The potential or actual receipt or use of principal as a result of a qualified trustee acting in its sole discretion, or at the direction of an adviser
- The potential or actual receipt or use of principal pursuant to an ascertainable standard contained in the trust instrument
- The right to use trust property if the right may be enjoyed only in the sole discretion of the trustee or pursuant to an ascertainable standard

Settlor's Permissible Retained Powers

(continued)

- The right to reside in a residence transferred to the trust if the trust is a qualified personal residence trust described in Section 2702 of the Internal Revenue Code (a QPRT)
- The potential or actual receipt of income or principal to pay income taxes due on the income of the trust as a result of a qualified trustee acting in its sole discretion, or at the direction of an adviser
- The power to veto distributions from the trust
- A testamentary limited power of appointment or similar power
- The right to remove a trustee or adviser and to appoint a new trustee or adviser (other than a person who is a related or subordinate party with respect to the settlor within the meaning of Section 672(c) of the Internal Revenue Code)
- The right to serve as investment adviser to the trust
- BEWARE: Inadvertent retained rights!

No Fraudulent Conveyance

- No action of any kind may be brought for an attachment or other provisional remedy against property that is the subject of a qualified disposition, unless the action is to avoid the qualified disposition under Delaware's fraudulent conveyance law.
- Effectively one of the conditions of creating a valid trust under the Act is that the transfer to the trust must be a qualified disposition under the Act that is not deemed to be a fraudulent transfer under applicable Delaware law, because the assets of the trust could be subject to the claims of the transferor's creditors if the transfer to the trust violates Delaware's fraudulent conveyance law.

Exceptions: Persons Not Subject To The Act

The following two classes of persons are not subject to the provisions of the Act:

- Support or alimony in favor of such transferor's spouse, former spouse, or children or for a division of property in favor of such settlor 's spouse or former spouse; however, for purposes of this rule, a person is treated as a spouse or former spouse only if the person was married to the transferor at, or before, the time of the qualified disposition (does not apply to forced heirship, legitime or elective share).
- Any person who suffers death, personal injury, or physical property damage on or before the date of a qualified disposition, which death, personal injury or physical property damage is at any time determined to have been caused either by the act or omission of the transferor or another person for whom such settlor is or was vicariously liable.

Last In – First Out

In determining whether a creditor's claim has met the statute of limitations in circumstances in which more than one qualified disposition is made to the same trust, the assets will be treated on a last in, first out basis, and any distributions to the transferor shall be deemed to have been made from the assets most recently contributed to the trust.

Creditor Protection and the Bankruptcy Estate

- Section 548(e) of the Bankruptcy Code was amended in 2005 to address asset protection through self-settled trusts.
- The amendment to the Bankruptcy Code should have a positive impact on Delaware asset protection trusts because the amendment expressly permits the use of a domestic asset protection trust in the non-abusive circumstances permissible under current Delaware law. It effectively validated the use of Delaware asset protection trusts and cleaned up much of the confusion about how such trusts will be treated under federal law.

Provisions of the Bankruptcy Code Amendment

- The amendment grants to the bankruptcy trustee the power to pull back into the bankruptcy estate (and thereby make available to creditors) assets transferred by the debtor to an asset protection trust but only if the debtor made the transfer "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted" AND if the transfer was made in the last ten years.
- The fraudulent transfer definition in the Bankruptcy Code is almost identical to the Delaware fraudulent transfer laws that are referenced in the Delaware asset protection trust statute.
- The ten-year statute of limitations means that the bankruptcy trustee could only pull back fraudulently transferred assets if the transfer occurs within ten years prior to the commencement of the bankruptcy case.

Consequences of Bankruptcy Code on Delaware Asset Protection Trusts

- A properly created Delaware asset protection trust will not have any contributions to it that are fraudulent transfers and, consequently, the ten year statute of limitations for fraudulent transfers to self-settled asset protection trusts under the Bankruptcy Code should have no application.
- For fraudulent transfers, the Bankruptcy Code potentially lengthens the statute of limitations, but in some cases, it won't.

Transfer and Income Tax Consequences Of Asset Protection Trusts

Importance of Creditor Rights

- Generally, if a trustee has the power, in the exercise of the trustee's sole discretion, to distribute trust assets to the settlor, the settlor's creditors may claim the trust assets in satisfaction of the settlor's debts.
- A number of federal tax cases and other authorities have held that because the settlor's creditors can attach the trust assets, the settlor has not made a completed gift of the trust assets or the trust assets were includible in the settlor's gross estate.
- Conversely, there is substantial authority for the proposition that if the settlor's creditors can not reach the assets of a trust, the settlor can design a trust that is a completed gift and there is no estate tax inclusion, even though the trustee has the power, in the trustee's sole discretion, to distribute the trust assets to the settlor.
- The Internal Revenue Service has ruled expressly that a settlor who contributes assets to an Alaska asset protection trust has made a completed gift. However, the Service refused to rule on whether the assets contributed to such a trust would be includible in the settlor's gross estate.

Treatment as a Completed Gift or Incomplete Gift

- In cases where the settlor wishes to avoid making a completed gift, but wishes to obtain the asset protection benefits of the statute, the settlor may:
  - (i) retain the power to veto all distributions to beneficiaries; and
  - (ii) retain a testamentary limited power of appointment.
- Alternatively, the settlor may make a qualified disposition to a trust that may be treated as a completed gift so long as the grantor has not otherwise retained sufficient dominion and control over the assets of the trust to prevent treatment as a completed gift.

Federal Income Tax

- In general, Delaware asset protection trusts are taxed as grantor trusts because the trustee, as a nonadverse party, has the power to dispose of the beneficial enjoyment of corpus and income and to distribute the trust income to the settlor.
- However, it is also possible to design an asset protection trust to avoid treatment as a grantor trust by providing beneficiaries who have interests in the trust that are substantially adverse to the settlor's interest with a power to block distributions to the settlor.

4 Types of Delaware Asset Protection Trusts

It is possible to create an asset protection trust with any one of the following four income and gift tax results:

1. A completed gift and a grantor trust
2. A completed gift and a non-grantor trust
3. An incomplete gift and a grantor trust
4. An incomplete gift and a non-grantor trust

DING Trusts

- First PLR issued on August 27, 2001
- PLR 200148028 (Aug. 27, 2001); PLR 200247013 (Aug. 14, 2002); PLR 200502014 (Sept. 17, 2004); PLR 200612002 (Nov. 23, 2005); PLR 200637025 (June 5, 2006)

Requirements

- **Creditor Protection.** Must be an asset protection trust - - a trust is a grantor trust if the settlor's creditors can attach the trust's assets. Treasury Regulations Section 1.677(a)-1(d).
- **No Reversion.** Eligibility to receive discretionary distributions doesn't seem to constitute a reversionary interest as the term is commonly understood under Code Section 673.
- **Substantially Adverse Parties.** The trust income and principal may be distributed or accumulated in the trust only with the consent of the members of a "distribution committee", each of whom is an adverse party within the meaning of IRC Section 672(a).
- **No Spousal Attribution.**
  - (i) Spouse may be a discretionary distributee during the lifetime of the settlor
  - (ii) No QTIP trust
  - (iii) Grantor could exercise LPOA in favor of spouse or QTIP
- **LPOA.** Need a testamentary limited power of appointment to avoid completed gift, but this will not cause the trust to be a grantor trust.

Examples

The right type of asset protection trust for a particular client depends on his or her estate planning and income tax objectives. The following examples demonstrate just some of the possible applications for Delaware asset protection trusts.

Example 1: Saving state and local income taxes with a non-grantor trust/ incomplete gift

Settlor is an individual with several children who resides in the state of New York. Settlor has a sizeable portfolio of marketable securities and other intangible assets and is concerned about liability to potential future creditors. Settlor is in the highest federal income tax bracket and has a state tax rate of about 6.85%. Settlor does not wish to make a completed gift of his assets because he does not want to make a taxable gift or use any of his gift tax credit.

An asset protection trust that is both a non-grantor trust and the transfers to which will not be completed gifts could be a powerful planning tool for Settlor. Settlor could retain the right to receive distributions of income and principal from the trust, subject to the consent or direction of a Distribution Committee comprised of his children who are also potential discretionary beneficiaries. The trust will provide creditor protection over the trust assets and income accumulated in the trust and all of the trust's capital gains will avoid all New York state income taxation. The federal income tax imposed on the trust's assets would be the same in the trust as it would be if the assets were taxed to Settlor. Additionally, the transfer to the trust will not constitute a completed gift, so Settlor will not have to worry about transfer taxes. In the future, Settlor could release his testamentary limited power of appointment over the trust's assets in whole or in part, thus making a completed gift of some or all of the trust's assets.

If Settlor would have created a traditional revocable trust and funded it with $2,000,000 and achieved a 10% annual rate of return before taxes, the trust would grow to slightly less than $7,000,000 in 20 years assuming no distributions occur and the earnings are comprised of 6% ordinary income and 4% realized capital gains. The effective rate of tax on the trust would be 35.37% (38.6% federal rate on ordinary income; 20% federal rate of capital gains; 6.85% New York state rate on all income; New York taxes deducted in computing federal taxes). By contrast, if the same trust were settled in Delaware as described above, by avoiding New York income taxes the effective rate of tax would be reduced to 31.16%, and the trust would grow to over $7,573,000 in the same time period. Thus, merely by settling the trust in Delaware, the settlor would obtain asset protection for the trust property during the entire 20 year trust period and, at the end of that period, the property in the trust, potentially available for distribution to the settlor, would be $573,000 greater. If Settlor lived in New York city, his effective state and city tax rate could be as high as 11%, thus providing even greater savings than that demonstrated in this illustration.

Example 2: Protecting assets from future malpractice claims using a grantor trust/incomplete gift

Settlor is a doctor and is concerned about potential future medical malpractice liability due to the rising insurance deductibles and runaway jury verdicts that exceed insurance coverage. While Settlor has concerns about possible future creditors and would like to protect his assets, Settlor would like his current transfer tax and income tax situation to remain unchanged.

An asset protection trust that is a grantor trust and the transfers to which will not be completed gifts could provide the desired asset protection over Settlor's intangible assets (and possibly other assets that could be transferred to a limited liability company) while maintain his current tax situation. Settlor could retain the rights identified above, including the right to receive discretionary distributions of income and principal from the trust, or all of the income of the trust, as well as a limited power of appointment. The trustee of the trust could, in its discretion, distribute all of the assets of the trust back to Settlor if Settlor needed the assets for his or her health, education, support or maintenance in the future. The trust will provide creditor protection over the trust assets and all income, losses and credits of the trust will continue to be taxed to Settlor. Additionally, the transfer to the trust will not constitute a completed gift, so Settlor will not have to worry about gift taxes. In the future, Settlor could release his testamentary limited power of appointment over the trust's assets in whole or in part, thus making a completed gift of some or all of the trust's assets.

Example 3:
Pre-nuptial planning using a grantor trust/incomplete gift

Settlor has earned (or inherited) a relatively sizeable amount of assets during his life and is about to get married for the second time. Settlor and Settlor's family would like to preserve Settlor's assets for his children and they have some concerns that Settlor's soon-to-be wife could take half of his assets as a divorce settlement, a substantial portion of his assets as alimony or half of his assets, if Settlor should die, as a spousal elective share under a forced heirship statute. Settlor also has some concerns about possible future creditors. Settlor would like his current transfer tax and income tax situation to remain unchanged.

A Delaware asset protection trust could be a useful pre-nuptial planning tool for protecting Settlor's assets from his future spouse in the possible event of divorce or death. The only persons treated as a "spouse" with respect to the exception from the Act for alimony payments or a property division or distribution are persons married to a transferor at, or before, the time of the qualified distribution, and the Act specifically states that claims for forced heirship are not covered within the exception. Thus, the assets of the Delaware asset protection trust would be protected from any claims of Settlor's future spouse.

Example 4:
Completed gifts for the person who is concerned that he will need the assets in the future by using a grantor trust or non-grantor trust/completed gift

Settlor has earned a relatively sizeable amount of assets during his life and would like to make some completed gifts to his children using his gift tax exemption and annual exclusion amounts. However, Settlor is rather uncomfortable with the idea of giving away his money to his children for fear that sometime in the future the rest of his assets may dissipate and he will need the money that he gave as a gift to support himself. Settlor may or may not have some concerns about possible future creditors and would like to protect his assets.

An asset protection trust that is either a grantor trust or a non-grantor trust and the transfers to which will be completed gifts could provide a unique opportunity for Settlor to accomplish his transfer tax objectives of making gifts to his children while providing a potential "escape hatch" that could enable Settlor to receive distributions of income or principal of the trust, in the discretion of the trustee, if Settlor needs the assets. Because of the unique tax treatment of Delaware asset protection trusts caused by the fact that the trust's assets are out of the reach of Settlor's creditors, Settlor could retain the right to receive discretionary distributions of income and principal from the trust while still making a completed gift to his children. This option is not available if the trust is not an asset protection trust. It would obviously be a bad idea from a transfer tax perspective for Settlor to receive distributions from the trust after he made a completed gift of the assets, but the asset protection trust provides the Settlor with the possibility of receiving distributions and that may address his fears about making a completed gift. Of course, the trust will also provide creditor protection over the trust assets. A Delaware asset protection trust could be created as a grantor trust thus allowing Settlor to enhance the value of the gift by paying the income tax on the trust earnings, or as a non-grantor trust, if Settlor does not wish to spend any of his remaining money paying the income taxes of the trust.

Delaware Income Taxation of Trusts

General Principles

Delaware follows the federal income tax rules for determining whether a trust is a grantor or non-grantor trust.

- If a trust is a "grantor trust" for federal income tax purposes, then the trust is disregarded as a separate taxpayer under Delaware law.
- If a trust is a "non-grantor trust" for federal income tax purposes, it will be treated as a separate taxpaying entity and will be considered as either a *resident* or *non-resident* trust for Delaware state income tax purposes.
- A Delaware trust may be subject to taxation in another state that has some connection to the trust, depending upon the laws of that state.

Non-Grantor Trusts

A non-grantor trust is a *resident* trust for Delaware income tax purposes if:

- The trust is created by the will of a decedent who at death was domiciled in Delaware; or
- The trust is created by, or consists of, a person domiciled in Delaware; or
- During more than half of any taxable year, the trust has only one trustee who is either a Delaware resident individual, or a corporation, partnership or other organization having an office for the conduct of business in Delaware; or
- During more than half of any taxable year, the trust has more than one trustee and one of the trustees is a corporation, partnership or other organization having an office for the conduct of a trust business in Delaware; or
- During more than half of any taxable year, the trust has more than one trustee all of whom are individuals and one-half or more of whom are Delaware residents.

DNI and Nonresident Beneficiary Deductions

- Non-grantor resident trusts are potentially subject to the Delaware income tax imposed upon individuals.

- But resident trusts are allowed *both* an income tax deduction for the amount of their federal distributable net income that is actually distributed *and* an income tax deduction for the amount of their federal taxable income (including capital gains), as modified for Delaware purposes, that is set aside for future distribution to non-resident beneficiaries.

Delaware Trusts With No Delaware Resident Beneficiaries

- The practical effect of these two deductions is that a Delaware resident trust never pays any Delaware income tax (and is not even required to file Delaware income tax returns) unless the trust has one or more beneficiaries who actually reside in Delaware.

Delaware Trusts With Delaware Beneficiaries

- No set-aside deduction is allowed for the portion of any income accumulated in the trust that is deemed to be accumulated for the benefit of the Delaware resident beneficiaries.
- The set-aside deduction is still available for the portion of the income that is deemed to be set aside for the trust's non-resident beneficiaries.
- Plus, the trust is allowed an income tax deduction for the amount of its federal distributable net income that is actually distributed to Delaware residents as well as non-residents.
- Thus, a non-grantor resident trust is only subject to the Delaware state income tax to the extent there is income set aside for future distribution to Delaware resident beneficiaries.

Grantor Trusts

- If a trust is a "grantor trust" for federal income tax purposes, then it is disregarded as a separate taxpayer under Delaware law.
- If the grantor of the trust resides outside Delaware, the grantor is not subject to Delaware income taxation unless the trust has Delaware source income.
- If the grantor is a Delaware resident, the trust's income will be taxed on the grantor's Delaware state income tax return.

Income Taxation By Other States

- Whether or not a state other than the State of Delaware will impose a tax on the income of a particular trust first depends upon the law of that other state.
- Statutes purporting to tax the income of trusts vary from state to state. Some tax trusts based on the location of the settlor, the trustee, the beneficiaries, or some derivation of those factors.
- More than one state can tax the income of a trust at the same time.

Other States

- Connecticut - Chase Manhattan Bank v. Gavin.
- D.C. - District of Columbia v. The Chase Manhattan Bank.
- New York – In Mercantile-Safe Deposit & Trust Co. v. Murphy, the Supreme Court of New York, Appellate Division held that the New York statutes violate the due process clause of the Fourteenth Amendment of the Federal Constitution. In response, the New York State Tax Regulations were revised to provide explicitly that no New York State income tax will be imposed on a trust that otherwise satisfies the definition of a New York "resident trust" if all of the following conditions are met:
  - (i) All of the trustees are domiciled in a state other than New York States;
  - (ii) The entire corpus of the trust, including real and tangible property, is located outside of New York State; and
  - (iii) All income and gains of the trust are derived from, or connected with, sources outside of New York State, determined as if the trust were a nonresident trust.