

A PRACTITIONER-FRIENDLY GUIDE TO THE DELAWARE ASSET-PROTECTION TRUST

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Since July 9, 1997, when Governor Thomas R. Carper signed Delaware's Qualified Dispositions in Trust Act ("Delaware Act"), Wilmington Trust Company ("WTC") clients, including non-Delaware residents, have been using the Delaware Act to save taxes, to protect assets, and to accomplish other purposes summarized below. This article highlights key features of this kind of trust.

BACKGROUND

Traditionally, an individual could not create a self-settled trust (i.e., an irrevocable trust from which he or she could benefit) and protect trust assets from claims by his or her creditors. So, if a client created an irrevocable trust and gave the trustee discretion to use the income and principal for the client and his or her spouse and children, the client's creditors could reach all trust assets, even if the trust had a spendthrift clause.

As American society became increasingly litigious, interest developed in a trust in which the person creating the trust could retain some potential benefits that could not be reached by his or her creditors. Until 1997, this interest was satisfied only by a trust, often called an "asset-protection trust" ("APT"), created in a foreign jurisdiction.

The Delaware Act (12 Del. C. §§ 3570–3576) gave birth to the Delaware APT. Besides Delaware, the states that now have some form of APT law are Alaska, Colorado, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. We estimate that, since 1997, Delaware and non-Delaware residents have created over 1,000 Delaware APTs and that their market value exceeds \$2 billion. New trusts are signed regularly.

The Delaware APT is not for everyone. Instead, it is an option to consider along with other techniques for shielding assets (e.g., liability insurance, incorporation, tenancy-by-the-entireties property, homestead exemption, retirement plans, and IRAs).

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BENEFITS OF DELAWARE APTS

A trust that is structured as a Delaware APT may provide several benefits, including:

Save Taxes

Employ Tax Benefits Your client might be reluctant to give away assets to use part or all of his or her \$5 million gift- and GST-tax exemptions for fear that he or she will need the funds in later life. Although the tax treatment is less certain, the client should consider using a Delaware APT for these tax benefits because he or she may be a discretionary beneficiary of the trust and could get assets back in an emergency.

Reduce Federal Transfer Tax A client will save federal transfer tax if he or she makes a gift that incurs gift tax, if he or she lives at least three years after making the gift, and if his or her estate must pay estate tax. If a client makes the gift through a Delaware APT, he or she might be able to get funds back from the trust if needed.

Avoid State Death Tax If your client's state of residence imposes an estate or inheritance tax, he or she might be able to reduce that tax by making a gift before death. If the client makes the gift to a Delaware APT, he or she potentially could get funds back in the event of need.

Assure Favorable Tax Treatment for Grantor Trusts A client's payment of income taxes attributable to a grantor trust is not a taxable gift, and inclusion in a grantor trust of a provision that gives the trustee discretion to reimburse the client for such taxes will not cause the trust to be included in the client's gross estate, provided that, as is true under the Delaware Act, the client's creditors may not reach trust assets by reason of the inclusion of that discretion (Rev. Rul. 2004-64).

Avoid State Income Tax A client might try to use a Delaware APT to avoid income tax on undistributed ordinary income and capital gains of a trust imposed by a state that has not adopted the federal grantor-trust rules (i.e., Pennsylvania or Tennessee). Also, the IRS has ruled several times that APTs may be nongrantor trusts if they are structured so that distributions to the grantor are controlled by adverse parties. Consequently, your client might be able to avoid state tax on undistributed ordinary income and capital gains of a trust imposed by one of the 42 states that follow the federal grantor-trust rules. As a nongrantor trust for state tax purposes, the client's home state may not tax the trust due to a lack of contacts with the trust and Delaware would not impose a tax on income accumulated for non-Delaware beneficiaries. In later years, your client possibly could receive tax-free distributions of the untaxed income.

Obtain Asset Protection

General Through success in business, savvy investing, or the receipt of a gift, inheritance, or personal-injury award, your client might own substantial assets outright. He or she could fund a Delaware APT with some of those assets to get protection from future creditor claims and business reverses.

Protect Young Adults' Assets A client should encourage his or her children to put assets that they receive (or may withdraw from a trust) at majority in a Delaware APT. Although the children may receive distributions from the trust, they will not have the unlimited ability to squander them.

Provide Pre-Marital Planning Because Delaware APTs are immune from claims by future spouses, a client's children may use them to shield assets from those claims without providing the financial disclosure that is required to implement effective pre-nuptial agreements.

Protect Officers and Directors If your client is a corporate officer or director, his or her activities are receiving increased scrutiny. With this in mind, he or she should consider shielding some assets through a Delaware APT.

Protect Vulnerable Persons If your client is mentally, physically, or financially vulnerable, he or she should consider using a Delaware APT to protect assets.

Protect Estate-Planning Vehicles

Several common estate-planning vehicles (e.g., CRTs, GRATs, and QPRTs) are self-settled trusts and therefore are vulnerable to creditor claims. In fact, two courts have included the debtor's interest in a CRT in the bankruptcy estate (Mack, 269 B.R. 392; Mennotte, 303 F.3d 1261), and one court has included the debtor's interest in a QPRT in the bankruptcy estate (Earle, 307 B.R. 276). The Delaware Act extends protection to these arrangements.

Provide Options for NRAs

If your client is a nonresident alien ("NRA"), he or she should consider a Delaware APT for two purposes. First, a Delaware APT is a viable estate-planning and asset-protection option for an NRA, whether or not he or she has family members in this country. Second, if your client is considering immigrating to the United States, he or she might want to create a Delaware APT to take advantage of the favorable tax treatment afforded lifetime gifts by NRAs prior to immigration and to keep the ability to get funds back if needed.

Provide Protection for Existing Trusts

If your client has created a self-settled trust in a state where it does not have protection from creditors, he or she should explore moving it to Delaware. Similarly, for a number of reasons, a client might want to relocate a foreign APT to Delaware.

HOW TO CREATE A DELAWARE APT (12 Del. C. §§ 3570(8), (11), 3571)

To create a Delaware APT, a client must establish an irrevocable trust that contains a spendthrift clause, designates Delaware law to govern the trust, and appoints at least one "Delaware trustee." A "Delaware trustee" is an individual who lives in Delaware (except the client) or a Delaware

trust company that performs certain duties. The trust may have non-Delaware cotrustees and Delaware or non-Delaware advisers.

The Delaware Act specifically permits a client to have the power to:

1. Consent to or direct investment changes;
2. Veto distributions; and/or
3. Replace trustees or advisers.

The Delaware Act also expressly authorizes your client to have one or more of the following:

1. The ability to receive income or principal pursuant to broad discretion or a standard;
2. The right to receive current income distributions;
3. An interest in a CRT or a QPRT;
4. Up to a 5% interest in a total-return unitrust or a GRAT;
5. A power, which the client may exercise by Will or another document, to appoint the principal in the trust at death to or for anyone except the client, the client's estate, the client's creditors, or the creditors of the client's estate;
6. The ability to be reimbursed for income taxes attributable to the trust on a mandatory or discretionary basis; or
7. The power to provide for the payment of taxes, debts, and expenses payable at the client's death.

Under the Delaware Act, any "understanding" that your client will receive money whenever he or she asks is void.

A Delaware APT may be funded with tenancy-by-the-entireties property without destroying protection from each spouse's separate creditors.

DRAFTING ISSUES

Unauthorized Provisions

Because not specifically permitted by the Delaware Act, a Delaware APT should not:

1. Appoint the client trustee or cotrustee;
2. Provide that the client will get trust assets back at a certain age or after a certain amount of time;
3. Authorize the trustee, adviser, protector, or committee to terminate the trust; or
4. Authorize the trustee to reimburse the client for gift taxes.

Unwise Provisions

Although permitted by the Delaware Act, a Delaware APT should not, in certain circumstances:

1. Appoint a cotrustee in the state where the client lives or works; or

2. Give the client the power to replace the trustee.

FUNDING ISSUES

General

Your client should fund a Delaware APT with assets that he or she never expects to need. A rule-of-thumb for avoiding a fraudulent transfer (see below) is to fund a Delaware APT with one-third to one-half of your client's surplus assets that are not already exempt from creditor claims after he or she performs an analysis of existing and foreseeable assets and liabilities.

Intangible Property

The best assets to put in a Delaware APT are cash, stocks, and bonds.

FLP-LLC Interests

Interests in an FLP or LLC are good assets to put in a Delaware APT, provided that your client is not the general partner or the manager and that the entity does not own real estate outside Delaware.

Non-Delaware Real Estate

Your client should not put real estate outside Delaware in a Delaware APT because it will give non-Delaware courts jurisdiction over the trust and a basis for applying non-Delaware law. Putting non-Delaware real estate in an FLP or LLC and funding the trust with interests in that entity might help, but this strategy has not been tested.

Custody

To prevent a non-Delaware court from having jurisdiction, WTC should have custody of all assets of a Delaware APT.

FEDERAL TAX CONSEQUENCES

Income Tax

A Delaware APT usually will be a grantor trust for federal income-tax purposes, which means that the client—not the trust—must pay all income taxes on interest and dividends that the trustee receives and on capital gains that the trust incurs (IRC § 677). The IRS has ruled several times, though, that such a trust is a nongrantor trust, which means that the trustee—not the client—must pay all such income taxes, if distributions to the client are controlled by adverse parties (e.g., children who will receive assets that are not distributed to the client) (see PLR 200731019). Although the IRS announced in 2007 that it is studying one aspect of the structure approved by these rulings (IR 2007-127), there are other ways to address that issue (e.g., by

appointing a three-member power of appointment committee in which a member who ceases to act is not replaced) so that a client may use this strategy while the IRS's study is ongoing.

Gift and Estate Taxes

If the trust gives the trustee or someone else discretion to distribute trust funds to your client and if your client retains a power of appointment and a power to veto distributions, he or she will not make a taxable gift when he or she creates a Delaware APT (Reg. § 25.2511-2(b)). However, if a client does not keep those powers, he or she probably will make a taxable gift when he or she creates a Delaware APT and the trust probably will not be included in the gross estate.

GST Tax

If the creation of a Delaware APT is a completed gift and if the trust is not includable in the gross estate, a client may allocate GST exemption at the creation of the trust.

DISTRIBUTION ISSUES

General

As mentioned above, your client should fund a Delaware APT with assets that he or she doesn't expect to need. If the Delaware APT gives the trustee discretion to use income or principal for the client, WTC will process requests for distributions in accordance with our usual procedures. For the trust to work, the client must give up control. So, he or she should request discretionary distributions rarely, if ever, and should not expect to use the trust as a checking account or to get money whenever he or she asks. If the client prefers, he or she may retain the right to receive regular income or unitrust distributions along with the ability to receive principal distributions on a discretionary basis.

Income Taxes

A Delaware APT typically will be a grantor trust for federal income-tax purposes so that your client will have to pay income taxes on trust income and capital gains that he or she does not actually receive. The client should keep enough money to pay those taxes and should not ask the trustee every April to exercise its discretion to give the client money to cover them. Alternatively, the trust may direct the trustee to pay (or reimburse the client for) such taxes.

MOVING TRUSTS TO DELAWARE (12 Del. C. §§ 3570(10), (11), 3572(c), 3575)

The Delaware Act provides for the move to Delaware of self-settled trusts created in other states or abroad, and the time that the trust existed before it is moved counts toward the four-year period (see below) during which a creditor may pursue a claim against the trust. Thus, your client might be able to move an existing self-settled trust to Delaware that cannot be defeated under the Delaware Act.

AVOID FRAUDULENT TRANSFER

If a client makes a transfer, whether he or she gives money to children, establishes an FLP, or creates a Delaware APT, and does not keep enough assets to pay existing and foreseeable creditors, your client has made a fraudulent transfer and the transfer may be undone. So, your client is a good candidate for a Delaware APT if he or she has surplus assets after performing a realistic assessment of existing and foreseeable assets and liabilities. Conversely, your client is a bad candidate for such a trust if he or she has—or is about to incur—a large obligation and wants to hide assets to avoid paying it. Nevertheless, if your client must meet a specific debt or claim, he or she may consider a Delaware APT for assets that aren't needed to satisfy that obligation.

To ensure that your client doesn't make a fraudulent transfer when establishing a Delaware APT, WTC will require him or her to provide background information and to complete a solvency letter.

WHO MAY DEFEAT A DELAWARE APT (12 Del. C. §§ 3572–3573)

The Delaware Act bars original actions and actions to enforce judgments, including judgments entered outside Delaware, and it requires a creditor to bring an action against a Delaware APT in the Delaware Court of Chancery.

Under the Supremacy Clause of the U.S. Constitution, certain “super creditors,” such as the IRS, the SEC, the FTC, and minor children seeking support, may reach the assets of vehicles (e.g., tenancy-by-the-entireties property and domestic APTs) otherwise shielded from creditors by state law. Under the Delaware Act, the following four categories of creditors may reach the assets of a Delaware APT:

Pre-Transfer Claims

If a creditor's claim arises before your client creates a Delaware APT, that creditor must bring suit within four years after creation of the trust or, if later, within one year after the creditor discovered (or should have discovered) the trust. The creditor also must prove by clear and convincing evidence that creation of the trust was a fraudulent transfer.

Post-Transfer Claims

If a creditor's claim arises after your client creates a Delaware APT, that creditor must bring suit within four years after the trust's creation and must prove by clear and convincing evidence that creation of the trust was a fraudulent transfer as to that creditor.

Family Claims

A spouse, former spouse, or minor child who has a claim resulting from an agreement or court order for alimony, child support, or property division may reach the assets of your client's Delaware APT at any time, but a spouse whom the client marries after creating the trust may not

take advantage of this exception. A surviving spouse probably will not be able to reach the assets of a Delaware APT by electing against the Will.

Tort Claims

A person who suffers death, personal injury, or property damage before the client establishes a Delaware APT for which your client is liable may reach trust assets at any time.

CONSEQUENCES IF A DELAWARE APT IS DEFEATED (12 Del. C. § 3574)

If a creditor proves that one of the above exceptions applies, your client's Delaware APT will be defeated only to the extent necessary to pay that creditor's claim and related costs, including attorneys' fees. Thus, each creditor must bring a separate action against the trustee. Unless a creditor proves that the trustee acted in bad faith, that trustee may use trust assets to pay its costs of litigating the claim before satisfying the claim. A beneficiary (including your client) who received a distribution before a creditor brings a successful suit to defeat a Delaware APT may keep the distribution unless the creditor proves that the beneficiary acted in bad faith. The Delaware Act protects trustees, attorneys, and other advisers who work on a Delaware APT.

INFRASTRUCTURE

An important factor in evaluating the effectiveness of Delaware APTs is that Delaware has a long-standing tradition of leadership in the trust industry. The original Delaware Act was written and enacted over a three-month period in 1997, and amendments have been drafted and enacted in short order. To date, no Delaware APT has been tested in court, but, in other situations, Delaware judges have upheld Delaware statutes in difficult cases, such as those that might arise if creditors were to challenge a Delaware APT.

DEFENDING DELAWARE APTS

If your client lives in Delaware or if he or she is an NRA, creditors should not be able to reach the assets of his or her Delaware APT except in the situations mentioned above. If your client does not live in Delaware but is a resident of the United States, a Delaware APT should afford the same protection, but this cannot be guaranteed because issues under the U.S. Constitution might come into play. The danger is that a court in a state that doesn't recognize APTs might decide that its law—not Delaware law—applies and order the trustee to pay a creditor, even if the claim is not one that is recognized under the Delaware Act.

There are several reasons why your client's trust should stand even if he or she is not a Delaware resident or an NRA. They include:

1. A judgment against a client is not binding on the trustee of the client's valid trust;
2. A non-Delaware court may not enter a judgment that binds the trustee of a Delaware APT if it does not have jurisdiction over trust assets or a trustee;
3. A non-Delaware court should defer to Delaware courts on issues that involve a Delaware trust;

4. A non-Delaware court should apply Delaware law—not its own law—on questions involving a Delaware APT;
5. Delaware may set deadlines for the enforcement of judgments from other states;
6. Delaware courts might not have to recognize (i.e., give full faith and credit to) judgments that non-Delaware courts enter against a trust; and
7. Creditors should not be able to reach a Delaware APT if your client ends up in bankruptcy, even after the 2005 amendments to the federal bankruptcy law.

RESOURCES

You might find the following resources helpful in designing and implementing a Delaware APT for your client:

- **The current Delaware Act**
delcode.delaware.gov/title12/c035/sc06/index.shtml
- **WTC's client letter summarizing the Delaware APT**
wilmingtontrust.com/repositories/wtc_sitecontent/pdf/articles/wilmington_trust_dapt_client_letter.pdf
- **WTC's solvency letter**
wilmingtontrust.com/repositories/wtc_sitecontent/pdf/articles/wilmington_trust_solvency_letter.pdf
- **WTC's Delaware APT form for an incomplete gift**
wilmingtontrust.com/repositories/wtc_sitecontent/pdf/articles/wilmington_trust_irrevocable_trust_agreement_incomplete_gift.pdf
- **WTC's Delaware APT form for a completed gift**
wilmingtontrust.com/repositories/wtc_sitecontent/pdf/articles/wilmington_trust_irrevocable_trust_agreement_completed_gift.pdf
- **Planning and Defending Domestic Asset-Protection Trusts**
wilmingtontrust.com/repositories/wtc_sitecontent/pdf/lib-wp-domesticassetprotection.pdf

CONCLUSION

No court has yet considered how effectively a Delaware APT protects assets, so the Delaware APT is not yet fail-safe. But, a properly designed and implemented Delaware APT will raise formidable obstacles for creditors. The Delaware APT also offers planning options that might be of great benefit to your clients.