

DELAWARE ASSET PROTECTION TRUSTS: BASICS AND OPPORTUNITIES

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I. Introduction.

The purpose of this article is to provide an overview of (i) the basic concepts of an Asset Protection Trust and (ii) the possible planning opportunities that may exist in creating such a Trust.¹ Given our experience with the Delaware Qualified Dispositions in Trust Act (the "Act")² and the many unique advantages of Delaware law, we will limit our discussion to the Act (although many of the issues are applicable to other State asset protection trust statutes).

II. What is an Asset Protection Trust?

An Asset Protection Trust is an irrevocable trust in which the person creating the Trust (i.e., the Grantor) is permitted to retain a beneficial interest yet creditors are generally not able to gain access to the underlying Trust assets. The theory is that if you have transferred control over the Trust assets to a third party, creditors should not be in a position to force distributions from the Trust. In other words, a creditor should not have any greater rights to the Trust assets than you.

Prior to the enactment of specific asset protection trust legislation, a person was generally not permitted to establish a trust, retain a beneficial interest, and at the same time prohibit creditors from gaining access to those assets. In 1997, Alaska introduced

the first asset protection trust legislation. Delaware quickly followed with the Act. There are currently eight (8) other states with similar legislation that has abolished the rule against self-settled trusts.

III. Mechanics of Establishing an Asset Protection Trust.

It is relatively easy to take advantage of the Act. Specifically, you need a transfer of assets to an irrevocable spendthrift trust governed by Delaware law.³ At least one trustee must be a "qualified trustee" which means that it must be a Delaware resident or an entity authorized by Delaware law to act as a trustee. Finally, the qualified trustee must materially participate in the administration of the Trust. In other words, you need some level of trust administration in Delaware such as maintaining custody of at least some of the assets in Delaware or maintaining the trust records in Delaware. While the Act may only require minimal ties to Delaware, for jurisdictional reasons it may be prudent to make certain that the Trust has stronger ties to Delaware.

IV. Exceptions.

There are several limitation periods and exceptions to the Act that must be considered in determining whether to create an Asset Protection Trust. Specifically, for pre-transfer claims the creditor must bring suit within four (4) years of the transfer or, if later, within one (1) year after the creditor discovered or should have discovered the transfer to the Trust. For post-transfer claims the creditor must bring suit within four (4) years of the transfer. There are certain "tacking provisions" which can be used in determining the claims period when moving trusts to Delaware. It is important to note

that the creditor must demonstrate by *clear and convincing* evidence that the transfer was fraudulent.

For public policy reasons, there are two classes of creditors that are exempt from the Act. First, spouses (alimony) and children (support) are excluded. As discussed below, however, a spouse is only excluded if the Grantor was married to the spouse at the time of the transfer. Second, certain tort injuries are excluded if such injuries arose prior to the transfer.

V. Who Would be Interested in Creating an Asset Protection Trust?

Given the reference to *asset protection*, people are often surprised by the variety of planning opportunities that are available through the use of an Asset Protection Trust. Specifically, an Asset Protection Trust may make sense in the following situations:

a. Creditor Protection. Individuals in high risk professions (such as doctors, lawyers, accountants, financial advisers, business owners, and corporate officers and directors) who have no foreseeable creditor claims would make ideal candidates for an Asset Protection Trust. In addition, individuals who receive substantial gifts or inheritances outright may wish to consider an Asset Protection Trust. If assets are placed in an Asset Protection Trust and the limitation periods discussed above have passed, the assets in the Trust should be outside the reach of creditors.⁴

b. Income Tax Planning. If created as a non-grantor trust under the Internal Revenue Code of 1986 (the "Code"),⁵ Delaware law provides that to the extent the income (including capital gains) is accumulated for non-resident beneficiaries, Delaware will not tax this income.⁶ Depending on the laws of the Grantor's state of

residence, it may be possible to avoid state and local income tax on this accumulated income.⁷ The problem, however, is that it is extremely complicated to prepare an Asset Protection Trust as a non-grantor trust given the Grantor's retention of the ability to receive income (or by reason of any other type of retention of control). In general, in order to have an Asset Protection Trust treated as a non-grantor trust, the typical approach would be to use an "adverse party" or a committee of adverse parties to consent to distributions to the Grantor and for the accumulation of income. This clearly can result in a loss of control for the Grantor given the possibility of the adverse party blocking distributions to the Grantor. However, through the use of a committee (or a group of adverse parties), it may be possible to provide a certain level of comfort that at least one adverse party will consent to a distribution to the Grantor.

If the Trust has been drafted as a completed gift for federal gift tax purposes (as discussed below), it may make sense for tax planning purposes for the Trust to be treated as a grantor trust. The reason is that the Trust is in essence permitted to grow income tax free (i.e., the payment of the income tax by the transferor is not considered to be an additional gift to the Trust).⁸ Establishing the Trust as a grantor trust may depend on the Grantor's ability to pay the income taxes from assets outside of the Trust. If the Grantor has insufficient assets to pay the income taxes, non-grantor trust status may be preferable as care should be taken to avoid distributions on a regular or established basis (i.e., to avoid the risk of an "implied understanding" that the Grantor could re-acquire the Trust assets).

c. Transfer Tax Planning. It is possible to make a transfer to an Asset Protection Trust as a completed gift and thus, in theory, excluded from the Grantor's

taxable estate for federal estate tax purposes.⁹ This could become very useful for persons who should engage in transfer tax planning (so that future appreciation is excluded from the Grantor's taxable estate) but are reluctant to do so for fear that they may need the money at some point in the future. In essence, the Asset Protection Trust enables the Grantor to transfer assets out of his taxable estate for planning purposes yet if a liquidity problem arises in the future the assets remain as potentially available resources to the Grantor.

Unfortunately, there is a certain level of uncertainty as to whether the transferred assets will, in fact, be excluded from the Grantor's taxable estate. While the Internal Revenue Service has specifically ruled that for gift tax purposes there may be a completed gift to an Asset Protection Trust, the Service has declined to rule on the estate tax implications. The reason, most likely, is that the Service is concerned about situations where there is an implied understanding that the Grantor can re-acquire the assets. For example, if the Grantor were to transfer the bulk of his assets to an Asset Protection Trust, a question may arise as to how the Grantor would maintain his standard of living without the use of these assets. In such a case, the assets should be includable in the Grantor's taxable estate. Another concern with a completed gift is that it may not make sense to make a completed gift if the assets will likely be distributed back to the Grantor's estate.

d. Protection from Oneself. Parents (or grandparents) often establish custodial accounts for their children and make annual exclusion gifts to these accounts. One problem with these accounts, however, is that when the child attains the age of twenty-one (21), the assets must be distributed outright to the child. Given the potential

for these accounts to have significant value, parents could try to convince the child upon distribution to immediately transfer the assets to an Asset Protection Trust. A similar concern could also arise in a "minor's trust" where the terms of the trust provide for an outright distribution at a particular age and, for whatever reason, the parent is concerned about the child's ability to handle the assets appropriately. Finally, certain individuals may be wise enough to recognize their vulnerability or general inability to handle their own affairs. In all such cases, the use of an Asset Protection Trust may make sense.

e. Marital Planning. An Asset Protection Trust is also a good option to consider for premarital planning (often as an alternative or in conjunction with a premarital agreement). As mentioned above, the definition of a spouse under the Act does not include someone who was not married to the Grantor at the time of the creation of the Trust. Thus, a person could place some of his assets in an Asset Protection Trust prior to marriage and, if divorced, the assets of the Trust would be immune from spousal claims in certain circumstances. Given the emotional issues that often arise in connection with a premarital agreement (and given the financial disclosures), the Asset Protection Trust represents a good alternative as the spouse-to-be need not be made aware of the transfer to the Asset Protection Trust.

f. Charitable Planning. In essence, any self-settled trust in which a person retains an interest can be established as an Asset Protection Trust. For example, a Grantor's retained interest in a Charitable Remainder Trust ("CRT")¹⁰ can be protected by establishing the CRT as an Asset Protection Trust. In addition to general creditor protection, a CRT set up as an Asset Protection Trust may be possible to avoid the spousal consent issue that was recently raised by the Internal Revenue Service in Rev.

Proc. 2005-24. In this Revenue Procedure, the Internal Revenue Service announced that a CRT will not qualify for tax-favored status in certain circumstances unless the Grantor's spouse waives the right to reach the CRT assets if he elects against the Grantor's estate.¹¹ The Act is clear that an interest in an Asset Protection Trust may not be used to satisfy a surviving spouse's elective share rights.¹²

g. Pre-immigration Planning. Non-resident aliens are permitted to create trusts with intangible personal property free of federal gift (and generation-skipping transfer) tax consequences. Thus, if a non-resident alien transfers assets to an Asset Protection Trust as a completed gift and then immigrates to the United States, he is permitted to retain an interest in the Trust and the assets should be excluded from his taxable estate.

VI. How Much Control Should the Grantor Retain?

It is important to remember that a person creating an Asset Protection Trust must be willing to part with substantial control over the transferred assets. As such, people often express reluctance in creating such a Trust. One of the first questions that a person may ask in creating an Asset Protection Trust is how can I get my money back. The short answer is that you cannot control this decision. Rather, the decision rests solely with the Trustee (or possibly a distribution adviser).

Fortunately, however, there are a variety of interests or powers that a Grantor is permitted to retain under the Act to alleviate these fears. Whether and to what extent a Grantor wishes to do so depends primarily on the purpose of the Trust. The reason is that these retain powers can have a significant impact on (i) the tax status of the Trust (i.e.,

grantor vs. non-grantor trust status and completed vs. incomplete gift) and (ii) the effectiveness of the Trust for asset protection purposes. As you can imagine, the more control that is retained, the less effective the trust may be for creditor protection purposes. One reason is that under Section 541 of the Bankruptcy Code,¹³ the bankruptcy estate includes all legal and equitable interests of the debtor. Thus, arguably, if a Grantor has retained a power, then the bankruptcy trustee would also have such a power. The issue generally comes down to a balancing of the Grantor's desire for control as compared to his desire to create an effective Asset Protection Trust. In addition, the more control that is retained the more likely the Trust will be considered a grantor trust for income tax purposes.

Under the Act, a Grantor is permitted to retain various rights and powers including, but not limited to: (1) the right to serve as the investment adviser of the Trust (on a direction or consent basis); (2) the power to veto distributions from the Trust; (3) the right to remove and replace trustees and other advisers provided that the successors are not related or subordinate to the Grantor within the meaning of Section 672(c) of the Code; (4) the right or potential to receive the income from (or a specified percentage, not to exceed 5, of) the Trust; (5) the potential to receive principal from the Trust in the discretion of the trustee (or an adviser) or pursuant to an ascertainable standard; (6) the right to distribute the balance of the Trust upon the death of the Grantor pursuant to a testamentary limited power of appointment; (7) the right to be reimbursed in the trustee's discretion or at the direction of an adviser for the income tax liability of the Grantor (by reason of the trust being treated as a grantor trust under the Code); and (8) the right to the use of real property held under a qualified personal residence trust.¹⁴

VII. Choice of Trustee.

One of the most important decisions in creating an Asset Protection Trust is to select the appropriate trustee. Often the decision requires balancing of the Grantor's desire to retain control over the transferred assets with his desire to create an effective Asset Protection Trust (i.e., the greater the retained control the greater the risk to effective asset protection).

As mentioned above, the Act requires at least one qualified trustee. One of the first questions that a Grantor may ask is whether or not he may serve as a trustee. The Act is clear that a transferor is not considered a qualified trustee.¹⁵ Moreover, the transferor would also be prohibited from serving as a co-trustee. Another question is whether a corporate or individual trustee should be selected. It seems clear that a higher level of creditor protection would be afforded by the use of an established and independent Delaware corporate trustee. The primary reason is that the use of an individual trustee could raise concerns of an implied understanding as to the Grantor's ability to access the assets at any time. However, a corporate trustee with an established method for determining discretionary distributions would reduce the risk of this line of attack. Disadvantages of using a corporate trustee may include increased fees and a perceived loss of control over the transferred assets.

Given the importance of administering the Trust in an appropriate manner, the use of an established corporate trustee is almost always preferred. However, even the use of a corporate trustee is not without risk of attack. Specifically, if the corporate trustee is a national trust company with operations in multiple states, a concern could arise that a

local court would assert jurisdiction.¹⁶ Many Delaware trust companies are structured independently in such a manner so as to alleviate this concern.

In order to address the control issues, a Grantor may request the use of an individual co-trustee to serve with a corporate qualified trustee.¹⁷ This raises several concerns that a Grantor must carefully consider. First, if a co-trustee is located in the same jurisdiction as the Grantor, a non-Delaware court may be more willing to assert jurisdiction over the Trust and there is the possibility that Delaware law might be determined to not govern the Trust. Further, the use of a spouse, friend or relative as a co-trustee could raise the implied understanding concern mentioned above. In general, an individual co-trustee is not recommended. One alternative to using a co-trustee is through the use of advisers as permitted by general Delaware law.¹⁸ The adviser could serve in a variety of capacities including, but not limited to, as an investment adviser or a distribution adviser (either on a consent or direction basis).¹⁹ The adviser could also have the power to remove and replace a trustee.²⁰ A Grantor may serve as an investment adviser or as an adviser who can veto distributions.²¹

VIII. Choice of Assets to be Contributed to the Trust.

It is important to select the appropriate assets (and the amount thereof) to fund an Asset Protection Trust. The ideal assets are generally marketable securities as opposed to any personal use type assets. It is often recommended to transfer the location of the property to Delaware so as to reduce jurisdictional arguments. In addition, the assets used to fund the Asset Protection Trust should be a small percentage (no more than one-third) of the individual's overall assets such that the individual would not be at a

significant loss if in fact the assets were never able to be transferred back to him. This limitation on the percentage to transfer may depend on the purpose of the Trust. For example, if the purpose is protection from oneself, it may be more appropriate to transfer a larger percentage of one's assets to the Trust.

Instead of contributing marketable securities directly to the Asset Protection Trust, it may make sense to first contribute the securities to a Delaware limited liability company and then to fund the Asset Protection Trust with the interest in the limited liability company. The idea is that if a creditor were to be successful in defeating the Asset Protection Trust, the creditor would merely become an assignee of the limited liability company with no real ability to acquire the underlying assets.

IX. Conclusion.

From sophisticated tax planning to creditor protection, an Asset Protection Trust represents a useful estate planning vehicle in a variety of situations.

¹ This article expands upon portions of an article that we previously authored entitled *Practical Considerations in Drafting a Delaware Asset Protection Trust*, 30 Tax Mgmt. Est., Gifts & Tr. J. 117 (Mar. 2005).

² 71 Del. Laws, c. 159, §1.

³ A spendthrift provision is a provision designed to (i) prevent the beneficiary from disposing of his or her interest in the Trust, such as by assignment, and (ii) limit the right of creditors to reach it, such as by attachment.

⁴ Much has been written about the validity of Domestic Asset Protection Trusts. While the consensus appears to be that if done correctly such Trusts are an effective vehicle for asset protection, after nearly nine (9) years on the books, the statutes have yet to be truly tested (and certain of the tax consequences remain somewhat uncertain). Despite this uncertainty, however, people are increasingly using Asset Protection Trusts for creditor protection purposes.

⁵ See §§ 671 through 679 of the Code.

⁶ 30 Del. C. §1636.

⁷ The issue depends on whether the State has adopted the federal grantor trust rules. It is also important to determine whether the Grantor is in the top federal income tax bracket because if the Trust is a non-grantor trust and the income is accumulated, given the condensed tax brackets for trusts, a higher federal income tax may be due.

⁸ Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

⁹ Treasury Regulation §25.2511-2(b). See PLRs 200247013, 200148028 and 200502014.

¹⁰ A Charitable Remainder Trust is a trust in which a Grantor retains a current interest (as an annuity or a unitrust) for a period of time and at the end of the term the balance of the assets pass to a charitable organization.

¹¹ The Internal Revenue Service recently announced in Notice 2006-15 that it was re-evaluating its position in Rev. Proc. 2005-24 and postponed the effective date of the Rev. Proc.

¹² See Richard W. Nenko, William H. Lunger and Mary B. Hickok, *Structuring CRTs as Delaware APTs to Provide Protection from Creditors and Surviving Spouses*, 46 Tax Management Memorandum 483 (Oct. 2005).

¹³ U.S. Code, Title 11.

¹⁴ A qualified personal residence trust is defined in §2702(c) of the Code.

¹⁵ 12 Del. C. § 3570(9)a. and 12 Del. C. § 3570(9)c.

¹⁶ In order for there to be an enforcement of creditor claims if a judgment is obtained, there must be jurisdiction over the trustee to enforce the judgment.

¹⁷ 12 Del. C. § 3570(9)f. provides that a disposition that is otherwise a qualified disposition shall not be treated as other than a qualified disposition solely because not all of the trustees are qualified trustees.

¹⁸ 12 Del. C. § 3313.

¹⁹ 12 Del. C. § 3570(9)c.2.-3.

²⁰ 12 Del. C. § 3570(9)c.1. As mentioned below, some commentators suggest that a transferor should not retain the ability to remove and replace a trustee even though it is a permitted power. A question arises as to whether it is appropriate to permit an adviser to do so if the adviser could be a related or subordinate party to the transferor (or if the adviser could be removed and replaced by the transferor)? Does this indirect method of control reduce the concerns of a transferor retaining a questionable power? If someone is concerned that a transferor should not have a particular power, it arguably does not make a difference if an adviser were instead to possess such a power even if the adviser is acting in a fiduciary capacity.

²¹ 12 Del. C. § 3570(9)d.