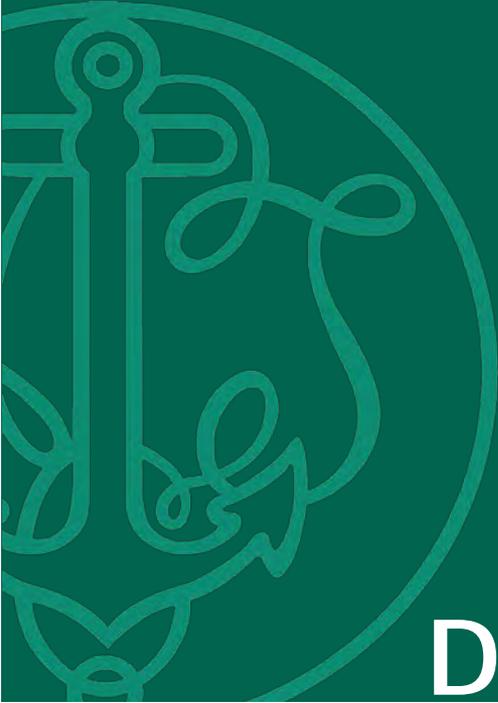


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Delaware Trusts:

Notable Developments from the Diamond State

April 18-19, 2012

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Delaware: Small Wonder



“You will have to come back tomorrow. Delaware has reached its capacity for today.”
-Allen Funt

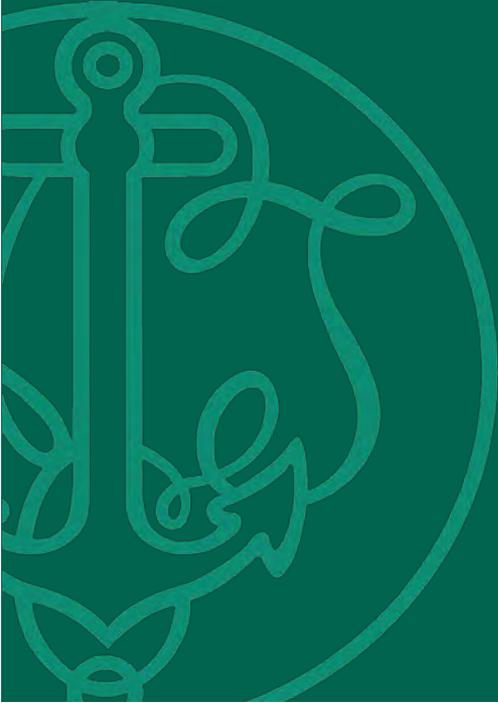


The Delaware Advantages

- Wealth Enhancement with Dynasty Trusts
- Administrative Trusts with Third-Party Advisors
- Asset Protection through Self-Settled Trusts
- Freedom of Disposition
- Savings on State Fiduciary Income Taxes



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Dynasty Trusts



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Dynasty Trusts

- In 1995 Delaware repealed its Rule against Perpetuities for personal property held in trust.
- Without RAP, a Delaware “dynasty” trust can continue for countless generations.
- Assets transferred to a GST-exempt dynasty trust can benefit each successive generation of the grantor’s descendants without incurring any additional gift tax, estate tax or generation-skipping transfer tax.





Dynasty Trusts: Post-TRA Strategies

- 2010 was largely a lost year because, for nearly the entire year, there was no GST exemption to allocate to a new dynasty trust.
- The passage of the Tax Relief Act of 2010 – with a \$5 million exemption for estate, gift and generation-skipping transfer (“GST”) tax purposes – has led to new planning opportunities with dynasty trusts in 2011 and 2012.





Dynasty Trusts: Post-TRA Strategies

- 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 new \$5 MM exemption; client sells appreciating asset to trust in return for a note with interest at AFR.
- Gifts to Discretionary Retained Interest Trusts – Client fully utilizes new exemption to make a completed gift but remains a discretionary beneficiary to recoup assets for dire needs (after all, \$5MM isn't \$1 MM).
 - Prior PLR 200944002 now in doubt.
 - Consider a Spousal Lifetime Access Trust instead.



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Direction Trusts



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“When you're a little kid you're a bit of everything: Scientist, Philosopher, Artist. Sometimes it seems like growing up is giving these things up one at a time.”

-- Kevin Arnold, *The Wonder Years*





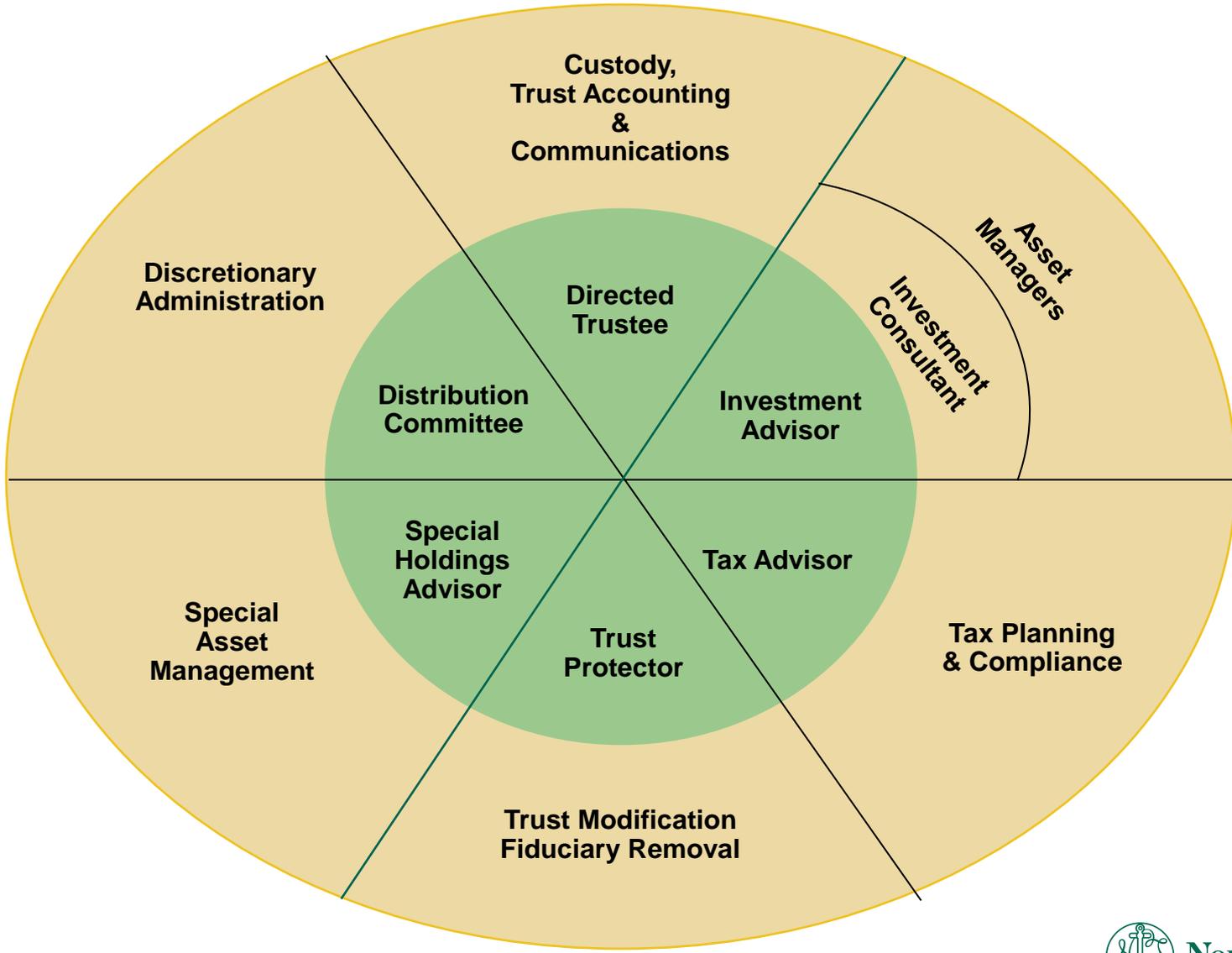
Direction Trusts

- Since 1986 Delaware law has allowed trustees to take direction from advisors (including investment advisors, distribution advisors and trust protectors), without liability for their decisions or results.
- Direction (or administrative) trusts represent a bifurcation of the trustee's duties, not a delegation under the Uniform Prudent Investor Act.





The Direction Trust as an Enterprise Trust





- Grantors who want to fund a trust with interests in closely-held entities and want to maintain control over the management of such entities.
- Non-U.S. grantors who want to maintain a trust with a U.S. trustee but want the trust treated as a foreign trust for U.S. income tax purposes. By giving a non-U.S. person authority over substantial decisions involving a trust, the trust will fail the “control” test and qualify as a foreign trust not subject to U.S. income tax except on U.S. source income.



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Asset Protection Trusts



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The Origins of Asset Protection



- Trusts had their inception in England in the 12th and 13th centuries.
- Crusaders who were landowners conveyed title to their properties to friends to pay and collect feudal duties on the properties in their absence.
- Upon the Crusaders' return, the trustees were to convey the properties back to the beneficiaries, who frequently turned to the Lord Chancellor to compel a reconveyance.





Asset Protection Trusts

- In 1997 Delaware became the second state to permit an “asset protection” trust, a trust in which the grantor retains an interest as a beneficiary.
- Currently, thirteen states permit asset protection trusts in some fashion: Delaware, Alaska, Rhode Island, Nevada, Utah, Missouri, Oklahoma, South Dakota, Colorado, Tennessee, Wyoming, New Hampshire and Hawaii. A Virginia statute is pending.





Asset Protection Trusts

- With a properly structured Delaware asset protection trust, the grantor may be a beneficiary of the trust and retain certain powers over the trust.
- 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.





Asset Protection Trusts

- 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.





Exempt Claims Can Reach 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. (*N.B., a “spouse” does not include one who marries the grantor after the transfer.*)
 - ◆ Tort claimants whose claims for death, personal injury or property damage precede the funding of the trust.



The Marital Problem

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"We've been married a long time in Hollywood years."



The Marital Solution To Avoid

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"Bad news, Kenny. When the judge awarded all your material goods and possessions to your wife, that included your socks."



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Premarital Planning Options

- Leave it to chance (and the judicial system)
- Use a revocable living trust
- Negotiate a prenuptial agreement
- Create a domestic asset protection trust





Planning Comparisons

Delaware Pre-Marital Trust

1. A trust is unilateral in nature, with the client working out the details of the trust with counsel.
2. The client need not disclose the existence of the APT.
3. Without disclosure of the trust, the client avoids the risk of an emotional discussion with the client's fiancé.
4. Under Delaware law, a trust is not subject to a spouse's claims for an elective share or forced heirship.
5. An APT is subject only to a claim that the grantor actually intended to defraud his or her future spouse.
6. A premarital APT is subject to challenge only during the four-year tail period.

Prenuptial Agreement

1. A prenup requires the cooperation of both parties and their counsel to negotiate a host of delicate issues.
2. Fair, reasonable and full disclosure of all assets is essential to validity.
3. Discussions of prenuptial agreements are often fraught with risk to the relationship.
4. Unless an agreement specifically excludes a spouse's elective share, the estate of a deceased client remains subject to spousal claims, potentially up to 50% of decedent's estate.
5. A prenup can be challenged if it was involuntary (duress, fraud, undue influence or lack of capacity), unconscionable or lacking in meaningful financial disclosure.
6. A prenup is vulnerable to challenge throughout the marriage and may terminate through a sunset clause.





Tenancy by the Entireties Trusts

- Delaware law allows co-grantors to transfer tenancy-by-the-entireties (TBE) property into an asset protection trust.
- TBE property transferred to a Delaware asset protection trust retains its TBE character until the death of the first grantor.
- Benefits of transferring TBE property to Delaware asset protection trust:
 - ◆ Creditor of grantors will have additional hurdle of proving fraudulent transfer if TBE property is held in trust.
 - ◆ If a creditor successfully reaches the assets of the trust, the sole remedy is an order directing the trustee to transfer the property to the co-grantors as TBE property.
 - ◆ When first spouse dies, TBE is destroyed and creditor of one spouse can reach the property; if TBE property is held in trust, creditor will be barred from reaching the property if claim is outside tail period.





What is the Effect of *Mortensen* on APTs?

- *In re Mortensen*, 2011 WL 5025249 (AK Br. 2011), determined that a bankruptcy trustee could rely on § 548(e) of the Bankruptcy Code to claw back the assets of an Alaska APT.
- The bankruptcy judge correctly determined that Mortensen's transfers to his trust were fraudulent, thus triggering a § 548(e) clawback.
 - ◆ Grantor transferred nearly all of his assets to his trust.
 - ◆ Grantor was facing "financial carnage" when he created the trust.



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Freedom of Disposition



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Freedom of Disposition: Confidentiality

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“Omigod—that’s your dirty little secret? That you have a trust fund?”



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Freedom of Disposition: Confidentiality

- Delaware trusts are not subject to any public registration or filing requirements.
- In the event of litigation, the Court of Chancery routinely seals the confidential aspects of trust proceedings.
- Delaware law even permits a trustee to withhold knowledge of a trust's existence from future or discretionary beneficiaries, if the grantor so directs. 12 Del. C. § 3303(a).





Freedom of Disposition: Protecting a Legacy

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“This will surely be disappointing to many meek people. The legacy has been successfully contested, and it is now the arrogant who are to inherit the earth.”



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Freedom of Disposition: Pre-Mortem Notice

- Delaware law permits a trustee to give interested persons notice of the creation of a trust. The notice starts a 120-day period to contest 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.



- Delaware law recognizes the validity of no-contest or in terrorem clauses in trusts and wills.
- The general rule enforcing a forfeiture does not apply to:
 - ◆ A beneficiary who “substantially prevails” in challenging the instrument.
 - ◆ An agreement in settlement of a dispute among the beneficiaries.
 - ◆ An action to determine whether a proceeding triggers the no-contest provision.
 - ◆ An action for construction of the instrument.



Freedom of Disposition: Decanting

- 12 Del. C. § 3528 authorizes Delaware trustees with the power to discrete principal to establish a resulting trust for the benefit of one or more “proper objects” of the first trust and fund the new trust with the assets of the first trust.
- Decanting does not require notice to, or consent of, the beneficiaries of the first trust or court approval.
- Section 3528 does not require a trustee to have absolute discretion to distribute principal.
- A Delaware trustee may rely on § 3528 upon its appointment as a successor trustee of an existing trust situated in another state.





- Achieving tax goals
 - ◆ Non-grantor to grantor status
 - ◆ Obtaining a tax-favored situs
 - ◆ Completing an incomplete gift in trust
 - ◆ Preserving NOLs of a trust asset
- Modifying beneficial interests
 - ◆ Granting or enlarging a beneficiary's power of appointment
 - ◆ Eliminating mandatory principal distributions
 - ◆ Excluding certain beneficiaries of first trust
- Changing administrative provisions



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Fiduciary Income Taxes



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Fiduciary Income Tax Savings

- Since 1971 Delaware has not imposed a fiduciary income tax on irrevocable trusts for non-resident beneficiaries.
- Absent a taxable connection or “nexus” with another state, capital gains and ordinary income can accumulate in irrevocable Delaware trusts without incurring a state income tax.
- It is common practice to move existing trusts to Delaware from certain high income tax states to avoid further state income tax on undistributed income.





Using a DING Trust to Defer State Income Tax

- In a number of states (e.g., NY, NJ, MA, AZ and OR), a grantor can contribute highly-appreciated assets to a DING trust to defer state income tax on the gain.
- Client may retain the right to receive income and principal from the trust. Client's trust will include other beneficiaries who may potentially receive distributions as well.
- To defer state income tax on the gain, the trust must have a Distribution Committee composed of other beneficiaries -- with the authority to approve distributions to client or client's spouse. Committee members should not be residents of grantor's home state.



- Grantor should retain a limited testamentary power of appointment, coupled with his to her beneficial interest, to avoid a completed gift.
- The Service has issued multiple PLRs supporting the non-grantor, incomplete gift nature of this sort of trust. *PLR 200729025, 200731019, 200715005, 200647001, 200637025, 200612002, 200502014, 200247013 and 200148028.*
- More recently, the Service opined in CCA 201208026 that a testamentary power of appointment alone is insufficient to prevent a transfer to an irrevocable trust from being treated as a completed gift. The CCA is distinguishable because its grantor retained no beneficial interest in the subject trust and had no veto power over distributions to other beneficiaries.





Potential Income Tax Savings

- *NYC resident owns \$50MM of zero-basis stock in a closely-held corporation. Client plans to sell to a private equity firm for cash.*

Post-sale Value of Asset

■ Delaware Trust =	\$42,500,000
■ New York Personal Assets =	<u>36,075,000</u>
■ Delaware Benefit =	\$6,425,000

Assumptions: Federal capital gains rate: 15.0%; NY state and city income tax rate: 12.85%; DE state fiduciary income tax rate: 0%. Actual results may vary from the illustration.



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Concluding Thoughts



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Other Jurisdictions (AK? NV? SD?)

- In contrast to the judicial system in other states, Delaware maintains a separate Court of Chancery, a non-jury court of equity, with exclusive jurisdiction over trust matters. The Court of Chancery is widely regarded as the premier business court in the nation.
- The Delaware General Assembly revises Delaware's trust laws annually to ensure that they remain effective and flexible.
- The presence of nearly every major corporate fiduciary in Delaware confirms Delaware's pre-eminent role as a trust jurisdiction.





Profile of Delaware Office

- The Delaware office opened September 30, 2004 as a trust office of Northern Trust Bank, FSB.
- Since 1/1/06 Northern's Delaware office has operated as a Delaware limited purpose trust company – The Northern Trust Company of Delaware.
- As of February 29, 2012, the Delaware office held in excess of \$10 billion in assets under administration.





Daniel F. Lindley

President, The Northern Trust Company of Delaware
Chief Fiduciary Officer, PFS – Guernsey and Cayman

Daniel F. Lindley is President of The Northern Trust Company of Delaware, a limited purpose trust company in Wilmington, Delaware. He is responsible for managing Northern's Delaware office. Dan also serves as the Chief Fiduciary Officer for Northern's international private client business, which is legally situated through trust affiliates in the Bailiwick of Guernsey and the Cayman Islands.

Prior to joining Northern Trust in 2005, Dan was Managing Director and Trust Counsel at U.S. Trust Company of Delaware. During his four years at U.S. Trust, Dan was responsible for, among other things, the national development of U.S. Trust's Delaware trust business.

Dan spent 25 years in private law practice in Delaware, beginning his career in 1975 with Potter Anderson & Corroon and later as an equity partner in the Delaware offices of Duane Morris LLP and Reed Smith LLP. During that time, he assisted institutional clients with fiduciary product development and fiduciary litigation, as well as the enactment of Delaware legislation dealing with fiduciary law. In that role, he was the principal author in 1997 of the Qualified Dispositions in Trust Act, Delaware's asset protection trust statute, and the 1995 legislation repealing Delaware's Rule against Perpetuities.

Dan holds a Juris Doctor degree from the University of Virginia School of Law and a Bachelor of Arts degree, *magna cum laude*, from Williams College. Admitted to the bars of the Supreme Court of the State of Delaware and the United States Supreme Court, Dan is a member of the Asset Protection Planning Committee of the Real Property, Probate and Trust Law Section of the American Bar Association. He is also a member of the Society of Trust and Estate Practitioners (STEP), the Estate Planning Council of Delaware, and the Estates and Trusts Section of the Delaware State Bar Association. Dan is chairman of the Executive Board of the Blood Bank of Delmarva, Inc.