

PERSPECTIVE



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SO YOU WANT TO CREATE A DELAWARE ASSET PROTECTION TRUST?

By Amy S. Brown, Vice President, Christiana Bank & Trust Company

By passing the "Qualified Disposition in Trust Act" in 1997, Delaware joined Alaska to become the second of currently ten states to permit individuals to create "asset protection trusts," so-named because if they are properly established, creditors of the Settlor (creator) cannot obtain a judgment against the trust's assets during the Settlor's lifetime. This legislation directly contradicts the common law position that an individual cannot protect his assets through a trust where he is the beneficiary.

CONTACT US

PERSONAL TRUST

Amy S. Brown
Vice President
3801 Kennett Pike
Greenville, DE 19807

Telephone
302.888.7740

Email
abrown@christianatrust.com

CORPORATE AND INSTITUTIONAL TRUST

Louis W. Geibel
Vice President
1314 King Street
Wilmington, DE 19801

Telephone
302.888.7424

Email
lgeibel@christianatrust.com

IN NEVADA

Doris J. Krick
Vice President
101 Convention Center Drive
Suite P109
Las Vegas, NV 89109

Telephone
702.732.9734

Email
dkrick@christianatrust.com



www.christianatrust.com

As background, the principle of spendthrift protection or protection against creditors is based on the traditional separation of legal ownership from beneficial ownership in a trust. A trustee holds legal title for management purposes, but beneficial ownership remains with the beneficiaries. Most states have adopted the concept of spendthrift protection for beneficiaries of trusts created by other people, but not protection for trusts created by the Settlor himself. Alaska and Delaware changed the rules for trusts by applying spendthrift protection to what we now call "self-settled trusts."

Should planners advocate techniques whose primary purpose is to subvert the legal creditors of a debtor? The answer is obviously no. Delaware law does not protect a Settlor if the transfer of assets to the asset protection trust is considered a fraudulent conveyance. Delaware defines fraudulent conveyances as "transfers made with the actual intent to hinder, delay or defraud any creditor," current and future, as well as those made that "render(s) the debtor insolvent or occur(s) at the time when the debtor is insolvent." Thus, bankrupt individuals or those being sued or awaiting suit cannot create an asset protection trust unless they retain sufficient assets to meet their obligations should they lose.

Statutory Requirements

The Delaware legislature passed the Qualified Disposition in Trust Act to encourage individuals to manage their affairs effectively and to permit the exclusion of creditors' claims against self-settled trusts. The statutory requirements are straightforward:

- The trust must be irrevocable. The Settlor cannot decide some time in the future that he wants his assets back because he no longer needs the APT.
- The asset protection trust must be administered by a "qualified trustee," defined as either a Delaware resident (other than the Settlor), or most often, an institution like Christiana Bank & Trust Company authorized under Delaware law to serve as trustee under the supervision of the Delaware Banking Commissioner, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), or the Office of Thrift Supervision.

Corporate trustees that are not incorporated in Delaware must create a Delaware presence either as a subsidiary with its principal place of business in Delaware or as a "limited purpose trust company." Otherwise, they do not meet the criterion as "qualified trustees."

Co-Trustees and other advisors like a Trust Protector or Investment Advisor are permitted (and encouraged) to make the trust's administration more responsive to the family. However, if the Co-Trustees are non-residents, Delaware's spendthrift provision may be compromised. Asset protection trusts may present a conflict of laws issue between Delaware and the state in which liability is incurred.

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The greater the number of “tentacles” or ties to Delaware, the stronger is the case for having decisions made in Delaware by the Delaware judiciary. Therefore, it’s better to use specific advisors for particular responsibilities rather than a non-Delaware Co-Trustee.

- “Qualified trustees” must participate “materially” in the administration of the trust by maintaining custody of the assets, preparing trust tax returns, or performing other administrative duties in Delaware.
- Delaware must serve as the trust’s situs (location) whose law governs the “validity, construction and administration” of the APT. This is consistent with the fiduciary principle that the law of the state in which the trust is administered is the law of the state that applies.

Delaware law provides that Delaware’s Court of Chancery retains exclusive jurisdiction over DAPTs; this has several practical ramifications. Adjudicating suits in Delaware improves the odds that the state’s spendthrift provision will be upheld. At the same time, making creditors come to Delaware can serve as an obstacle to out-of-state creditors. Being obliged to use the Court of Chancery is a good thing because the Court, an equity court, is well-known for the quality and sophistication of its judges who have many years of experience in dealing with trust issues. There is no jury trial, and appeals may only be made to the Delaware Supreme Court.

- The document must state that the interest of the Settlor or any other trust beneficiary in the trust property or the income generated by it cannot be “transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily,” before the property or income is actually distributed, and that this provision constitutes “a restriction on ... the transferor’s beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of § 541(c)(2) of the Bankruptcy Code (11 U.S.C. § 541(c)(2)) or any successor provision thereto.”

Besides its bankruptcy implications, the language is a critical component for the argument that an APT may be written as a completed gift for federal transfer tax purposes because the assets are not subject to the rights of creditors. The latter offers the potential for estate tax savings on the asset’s appreciation from the date of gift to the date of Settlor’s death. Although the IRS agreed that based on the facts of a particular case, the trust being evaluated was a completed gift, it pointedly refused to rule on the federal estate tax implications of the decision.

Settlor’s Control over a Delaware APT

To encourage individuals to establish irrevocable trusts with assets that cannot be returned to them, Delaware permits Settlers to retain one or more of the following powers without losing the APT’s asset protection:

- The potential or actual receipt of income and principal in the sole discretion of qualified trustee or authorized advisor
- The potential or actual receipt of income and principal in accordance with the ascertainable standard of health, maintenance, support and education
- The right to receive income and principal from charitable trusts that qualify for the charitable deduction
- The right to receive income and principal of up to five percent per year from unitrusts
- The right to live in a residence that forms the principal of a “qualified personal interest in trust” (QPRT)
- The right to serve as investment advisor and the right to veto distributions from the trust during a Settlor’s lifetime

More importantly, Delaware permits a Settlor to decide whether the transfer should be a completed gift on which federal gift taxes may be immediately due or an incomplete gift that is completed at the Settlor’s death. Not only does the inclusion of a limited power of appointment exercisable at Settlor’s death enable Settlor to change what happens to the trust’s assets among specified beneficiaries, it also provides needed flexibility to respond to a changed family situation.

Yet flexibility and access to the APT come at a cost: The greater the access, the greater the potential for creditors to reach the assets. As long as income and principal remain in the trust, creditors cannot attach them, but once the funds are distributed to beneficiaries, they are available for creditors as well.

Federal transfer taxes are based on control. If a donor gives away property irrevocably, the federal government says that he no longer owns the property because he has no control over the gifted property.



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Yet, the gifted property must be included on the federal estate tax return that tallies transfers made during lifetime and at death to which the individual's exemption equivalent is applied. If a Settlor transfers property to a trust from which he automatically receives income, he is considered to have retained control. The asset is then included in his estate at values determined as of his date of death. On the other hand, if a Settlor is a permissible recipient of income and principal at the trustee's sole discretion, he may be considered as lacking sufficient control.

To strengthen the discretionary provisions, Delaware enacted legislation stating that a trustee cannot be compelled to distribute income or principal to a beneficiary. Thus courts cannot require trustees to make discretionary distributions, and discretionary interests in APTs, as well as in other irrevocable trusts, are exempt from all legal or equitable process. Recent changes clarify that a beneficiary's interest in a trust whose income and principal are distributable only at the qualified trustee's sole discretion are only expectancies, not a property interest or enforceable right.

Who Is a Good Candidate for a Delaware Asset Protection Trust?

In an era of malpractice suits, doctors come first to mind, as well as other professionals like attorneys, accountants, and investment advisors. Premiums for medical malpractice insurance have grown exponentially, with the result that coverage may be unaffordable, minimal or nonexistent for doctors in certain specialties or particular states. Certainly, accountants involved in the Enron affair would have been well served if they had established asset protection trusts before Enron's problems were discovered.

Other candidates include the officers, directors and fiduciaries of corporations who might be sued for almost anything from environmental issues, the side effect of drugs, new medical procedures, or like McDonald's, for a spilt cup of coffee. Real estate developers and contractors concerned not only about environmental problems, but also about the effect of accidents that exceed their insurance coverage are also good candidates. Sports figures constitute another category; so many times, they are the victim of unscrupulous advisors whose advice has left them penniless at the end of their careers.

Or an individual might wish to protect himself from himself, such as gamblers (reformed or otherwise) or those who exhibit spendthrift tendencies. An heir to a substantial fortune might consider an APT for a portion of his inheritance. APTs are also an effective alternative to prenuptial agreements that may be a necessary but unromantic adjunct to the engagement.

On the other hand, the obligations of certain creditors will still be honored. Exceptions to Delaware's spendthrift protection include persons to whom Settlor owes child support or alimony or to any person who suffers death, personal injury or property damage [at the hands of Settlor] on or before the date of the qualified disposition. Creditors' claims that arose before the establishment of the APT can be "extinguished" if they are not presented to the Trustee within four years of the APT's creation or "when the obligation was incurred, or, if later, within one year" after the APT's creation when the "transfer was or could be reasonably" discovered by the creditor. The burden of proof is on the creditor.

Being solvent is a primary requirement for a DAPT. The candidate should have sufficient other resources and the mindset to regard assets transferred to the APT as "rainy day funds" that are unlikely to be needed in the foreseeable future. APTs are forever.

Potential settlors should never put all or the majority of their assets into a DAPT. Doing so creates one of the so-called "badges of fraud" that smacks of a fraudulent conveyance. For cost effectiveness, asset protection trusts probably require a minimum commitment of at least \$1,000,000.

Do Delaware Asset Protection Trusts Work?

Are Delaware asset protection trusts effective in offering spendthrift protection? The short answer is that the jury is still out. Several cases support Delaware's view that its "qualified disposition in trust" act offers a sustainable defense against creditors' claims arising in other jurisdictions, based on the premise that creditors sue individuals, not trusts in which these individuals have a beneficial interest. As long as there are no definitive cases on the points raised by Delaware's Qualified Disposition in Trust Act, there are no guarantees.

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Interestingly, the 2005 revision of the federal bankruptcy law gave de facto recognition of asset protection trusts that were not created by fraudulent conveyance. The Act added a ten-year "look-back" period in which the bankruptcy trustee could ignore any transfer made on or before ten years before the debtor filed for bankruptcy, thereby posing an additional hurdle to be overcome by creditors. The fraudulent conveyance language in the 2005 Act and the Delaware code mirror each other.

This article focuses solely on Delaware's asset protection trusts. Asset protection planning itself involves many other techniques that may be more appropriate or effective for a particular individual. To those who believe that asset protection planning is somehow immoral, I would respond that most estate planning professionals now consider asset protection planning to be as essential as tax planning and getting assets to chosen beneficiaries.



If you have clients for whom a Delaware Asset Protection Trust might hold some interest, we invite you to contact Amy Brown at 302.888.7740 for further information. In the Western United States, we invite you to contact Doris J. Krick in our Nevada office at 702.732.9734 for additional information.

RETIREMENT DISTRIBUTIONS RELIEF

IRA owners received an early Christmas present at the end of 2008 when Congress suspended the rule that requires mandatory withdrawals for individuals who attain age 70 1/2 in 2009. The suspension, which also applies to other individuals such as 401(k) participants and IRA beneficiaries who must withdraw funds from inherited IRAs over five years, is in effect for 2009 only.

What Congress Did

The withdrawal rules work like this: If you have a traditional IRA, you must begin to take a minimum annual amount from your IRA in the year that you reach age 70 1/2. The amount is based upon your account balance as of December 31 of the preceding year and your life expectancy. If you don't make a withdrawal or withdraw less than the correct amount, there's a big penalty—50% of the difference between what you should have withdrawn and what you actually did withdraw, in addition to the usual ordinary income tax that you pay on all distributions.

Congress has removed the 50% penalty from the books for 2009, eliminating the requirement to take money from your IRA if you don't need it. As it stands now, mandatory withdrawals will be in effect once again in 2010. For people who have inherited IRAs and are required to withdraw everything within a five-year period, if 2009 falls within those five years, the period is extended automatically by one year.

How Good Is This News?

If you've seen your IRA balance tumble, as most people have, it's a relief that you won't have to take a payout that would further deplete the account (or be forced to sell assets with depressed values that you would rather hold on to for now). And, of course, even as the markets recover, with less in your IRA, the harder it will be to bring the balance back to where it was before the decline.

The opportunity to avoid a withdrawal does not eliminate the need to pay income tax—it simply delays it. Using some round numbers, if you have, say, \$200,000 in your IRA right now, and your required payout were 4%, you would have withdrawn \$8,000. At an income tax rate of 35%, you would have owed \$2,800. You still will need to pay that amount when you eventually withdraw the money, as you do on all distributions from retirement plans.

There is a small economic benefit for the continued tax deferral on the \$8,000 for one year. Assuming that you earn 5% on that money for a year before it is withdrawn, it's \$400 more in your IRA. Not much, to be sure, but certainly welcome in times such as these.

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CHRISTIANA
BANK & TRUST
Subsidiary of National Penn

Greenville Center
3801 Kennett Pike
Greenville, DE 19807
302.888.7740

101 Convention Center Drive
Suite P109
Las Vegas, NV 89109
702.732.9734

1314 King Street
Wilmington, DE 19801
302.888.7424

www.christianatrust.com

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