

Practical Considerations in Drafting a Delaware Asset Protection Trust

by F. Peter Conaty, Jr., Esq.
and William H. Lunger, Esq.
Prickett, Jones & Elliott, P.A.
Wilmington, DE*

INTRODUCTION

The validity of Domestic Asset Protection Trusts has been addressed by a variety of commentators.¹ While the consensus among practitioners appears to be that such Trusts are an effective vehicle for asset protection and other planning purposes, after nearly eight years on the books, the statutes have yet to be truly tested and much remains to be seen. Moreover, certain of the tax consequences remain unresolved. Despite this uncertainty, many practitioners are increasingly recommending and implementing such Trusts on behalf of their clients.²

The purpose of this article is to explore some of the practical considerations that arise in drafting and effectively implementing a Domestic Asset Protection

Trust. While the specific requirements for establishing such a Trust are generally straightforward, there are a variety of unique issues and options to consider in the drafting process that may have a significant impact on the effectiveness of the Trust, whether for creditor protection or other planning purposes. Given our experience with the Delaware Qualified Dispositions in Trust Act (the "Act")³ 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 statutes.

INITIAL CONSIDERATIONS

Before discussing the practical issues in drafting a Delaware Asset Protection Trust, there are several initial considerations to review.

First, it is relatively easy to take advantage of the Act, which requires the following: (1) a disposition by or from a transferor by means of a trust instrument,⁴ (2) at least one trustee who is a Delaware resident or an entity authorized by Delaware law to act as a trustee,⁵ (3) the qualified trustee must maintain or arrange for custody in Delaware of at least some of the Trust's assets, maintain records for the Trust on an exclusive or nonexclusive basis, prepare or arrange for the preparation of fiduciary income tax returns for the Trust, or otherwise materially participate in the administration of the Trust,⁶ (4) the Trust agreement must provide that Delaware law governs the validity, construction, and administration of the Trust,⁷ (5) the Trust must be irrevocable,⁸ and (6) the Trust must contain a spendthrift provision.⁹

Second, there are multiple contexts in which a Delaware Asset Protection Trust may be utilized. The uses range from income, estate and gift tax planning, asset protection, pre- and post-marital planning, protection of charitable remainder trusts and other self-settled trusts, avoidance of state income or intangible taxes, to pre-immigration planning and elder law. The asset protection features under the Act should be considered for any type of irrevocable trust in which a

* Both authors are directors in the Tax Section of Prickett, Jones & Elliott, P.A. They practice primarily in the areas of estate planning and estate and trust administration.

¹ See generally, Richard W. Nenno, "Delaware Dynasty Trusts, Total Return Trusts, and Asset Protection Trusts," *Asset Protection: Domestic and International Law and Tactics* (2005); Richard W. Nenno, "Delaware Asset Protection Trusts: Avoiding Fraudulent Transfers and Attorney Liability," *Estate Planning* (Jan. 2005); Richard W. Nenno, "The Domestic Asset Protection Trust Comes of Age," 38 *U. Miami Inst. on Est. Plan.* ¶200 (2004); Richard W. Nenno, "Delaware Law Offers Asset Protection and Estate Planning Benefits," *Estate Planning* (Jan. 1999); Richard G. Bacon & John A. Terrill, II, "Domestic Asset Protection Trusts Work — Should They?," 26 *Tax Mgmt. Est., Gifts & Tr. J.* 123 (May/June 2001); Robert T. Danforth, "Rethinking the Law of Creditors' Rights in Trusts," 53 *Hastings L. J.* (Jan. 2002); Charles D. Fox IV & Michael J. Huft, "Asset Protection and Dynasty Trusts," *Real Property, Probate and Trust Journal* (Summer 2002); John E. Sullivan, III, "Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes With Offshore Trusts," 23 *Del. J. Corp. L.* 423 (1998); and Thomas O. Wells, "Domestic Asset Protection Trusts — A Viable Estate and Wealth Preservation Alternative," *Florida Bar Journal* (May 2003).

² It has been estimated that over \$2.0 billion is held in trust under the Delaware statute. As explained in more detail herein, the increase in the use of such Trusts can be attributed, in part, to a general recognition that asset protection represents an essential element to an overall estate plan and the fact that guidelines are now in place for practitioners to address the fraudulent transfer concerns which previously existed.

³ 71 Del. Laws, c. 159, §1.

⁴ 12 Del. C. §3570(6).

⁵ 12 Del. C. §3570(9)a. Such a trustee is referred to under the Act as a "qualified trustee."

⁶ 12 Del. C. §3570(9)b.

⁷ 12 Del. C. §3570(10)a. This requirement is not applicable if there is a disposition by a trustee that is not a qualified trustee to a trustee that is a qualified trustee. 12 Del. C. §3570(10)d. This is intended to encourage the transfer of trusts to Delaware.

⁸ 12 Del. C. §3570(10)b. As discussed below, the Trust will not be considered to be revocable on account of its inclusion of a variety of retained powers by the transferor. 12 Del. C. §3570(10)b.1.-8.

⁹ 12 Del. C. §3570(10)c.

transferor retains an interest. Even if asset protection is not a primary goal of the client (and one of the above uses is), there is no reason that the benefits of a Delaware Asset Protection Trust might not be used in conjunction with such other uses.

Third, a practitioner should take all precautions to avoid a claim for assisting in a fraudulent conveyance. Under Delaware law, a transfer is fraudulent if the debtor made the transfer (i) with actual intent to hinder, delay or defraud any creditor of the debtor, (ii) without receiving a reasonably equivalent value in exchange for the transfer; and the debtor (a) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (b) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.¹⁰ Although the Act specifically protects attorneys, advisors and trustees of a Delaware Asset Protection Trust,¹¹ there is no guarantee that a trustee, adviser or attorney would not be required to defend an action in connection with the transfer in the event that a creditor of the client instituted suit. Accordingly, it is imperative that the practitioner complete due diligence including a solvency analysis.¹² Moreover, in the event that you are a practitioner in a jurisdiction which does not have an asset protection statute, you should be certain that your advice does not violate any professional rules of responsibility in such jurisdiction.¹³

PRACTICAL CONSIDERATIONS

The Client

Identifying an appropriate client (or a situation) for a Delaware Asset Protection Trust represents an important consideration. While practitioners often do not have a choice in selecting a particular client, certain common characteristics can be used as a guide to determine which clients are appropriate candidates for

¹⁰ 12 Del. C. §1304.

¹¹ 12 Del. C. §3572(d) and (e).

¹² While a corporate trustee often assists in this process, it is important for the practitioner not to rely exclusively on the corporate trustee.

¹³ For a detailed discussion concerning the ethical considerations of asset protection planning, see Gideon Rothschild and Daniel S. Rubin, "Asset-Protection Planning Ethical? Legal? Obligatory?," 142 *Tr. & Est.* 42 (Sept. 2003); and Henry J. Lischer, Jr., "Professional Responsibility Issues Associated with Asset Protection Trusts," 39 *Real Prop. Prob. & Tr. J.* (Fall 2004).

such a Trust.¹⁴ For example, a client in a high risk profession (e.g., a doctor) is generally a good candidate to consider a Delaware Asset Protection Trust. Another appropriate client may be a person with substantial assets who is unwilling to make a substantial gift for fear (however unrealistic) of needing the property in the future. In such a case, a completed gift to a Delaware Asset Protection Trust may permit the shifting of appreciation to the client's beneficiaries and at the same time provide a level of comfort to the client that the assets could be accessed if needed. A client with a highly appreciating asset who may wish to retain an interest in the asset (e.g., a mandatory income stream) may also be an appropriate client.¹⁵ Overall, the client should be solvent, have no pending claims, have sufficient assets and be willing to part with substantial control over such assets, and be acting today to protect his or her assets from any future problems.

Regardless of whether your client is the ideal candidate, the practitioner must be extremely cautious when a potential client approaches regarding asset protection. As with all engagements, the practitioner should perform adequate due diligence. As part of this analysis, the practitioner should obtain written assurances from the client regarding assets and liabilities so that solvency can be determined.¹⁶ Given the complexities of the Act (let alone the theoretical and constitutional arguments for and against the effectiveness of the concept), the tax consequences, and the potential risks that may occur if the transaction is not respected, the practitioner should also adequately advise the client of the risks and consequences of the transaction in writing (including the potential consequences of any misrepresentations to the attorney or the falsifying of any financial statements or the misleading of creditors). Clear communications with your client is essential for all aspects of an Asset Protection Trust.¹⁷

¹⁴ It is interesting to note that a client need not be an individual. Rather, a transferor to a Delaware Asset Protection Trust could be a corporation or other entity. 12 Del. C. §3570(11).

¹⁵ The retention of such an interest would cause the Trust to be included in the transferor's gross estate for federal estate tax purposes.

¹⁶ The practitioner may also wish to receive written assurances from the client that the client is familiar with the appropriate fraudulent conveyance statute and that the contemplated transaction will not cause them to violate the client's state fraudulent conveyance act.

¹⁷ In making such communications, it is important for the practitioner to ensure the protection of the attorney/client privilege and to make sure the client understands the consequences of doing so. For example, copying a referral source on client communications may risk the loss of the privilege.

The Trustee

The question of who should serve as the trustee often comes down to balancing the client's wish to retain control over the transferred assets with his or her desire to create an effective Asset Protection Trust (i.e., the greater the retained control the greater the risk to effective asset protection).

The Act requires at least one qualified trustee.¹⁸ In drafting the successor trustee provisions, it is essential for the practitioner to ensure that a qualified trustee serve at all times. If not, the Act provides for its own successor trustee provisions (i.e., a court-appointed qualified trustee which may not be consistent with the client's wishes).¹⁹ The Act also provides that a qualified trustee will automatically cease to serve if it fails to meet the statutory requirements.²⁰

A client will often ask whether he or she may serve as a trustee. The Act is clear that a transferor is not considered a qualified trustee.²¹ Does this mean that a transferor is prohibited from serving as a co-trustee along with the qualified trustee? The short answer is yes. Section 3571 of Title 12 of the Delaware Code provides that except as otherwise permitted in §§3570(9)d. (a transferor may serve as an investment adviser) and 3570(10)b. (various permissible retained powers), a transferor shall have no rights or authority with respect to the property that is the subject of a qualified disposition or the income therefrom. This limitation would effectively prohibit a transferor from serving as a co-trustee. In general, it is also advisable to prohibit a related or subordinated party from serving as a trustee.

The next question is whether a corporate or individual trustee should be used. It seems clear that the best level of creditor protection is afforded by the use of an established and independent Delaware corporate trustee. The primary reason is that, as mentioned above, the use of an individual trustee could raise concerns of an implied understanding that the transferor could receive the assets back 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. The use of a corporate trustee is also not without risk of attack. For example, if the corporate trustee is a national trust company with operations in multiple states, a concern could arise that a local court would

¹⁸ 12 Del. C. §3570(6), 12 Del. C. §3570(9)a. and 12 Del. C. §3570(9)f.

¹⁹ 12 Del. C. §3570(9)e.

²⁰ *Id.*

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

assert jurisdiction.²² Many Delaware trust companies are structured independently in such a manner so as to alleviate this concern.

In order to address the control concern, practitioners may be inclined to suggest the use of an individual co-trustee to serve with a corporate qualified trustee.²³ This raises several concerns that a client must carefully consider. First, if a co-trustee is located in the same jurisdiction as the transferor, a non-Delaware court may be more willing to assert jurisdiction over the Trust and may also determine that Delaware law does not govern the Trust. Further, as mentioned above, the use of a spouse, friend or relative as a co-trustee could raise concerns of an implied understanding that the transferor could receive the assets back at any time. In general, an individual co-trustee is not recommended.

A client's concerns regarding loss of control are often best addressed through the use of an adviser as permitted by general Delaware law.²⁴ The adviser could serve in a variety of capacities including, but not limited to, an investment adviser or a distribution adviser (either on a consent or direction basis).²⁵ The adviser could also have the power to remove and replace a trustee.²⁶ A transferor may serve as investment adviser only or as an adviser who can veto distributions.²⁷

Selection of Assets/Funding

It is important to select appropriate assets to fund an Asset Protection Trust. The ideal assets are generally marketable securities as opposed to any personal

²² 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.

²³ 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.

²⁴ 12 Del. C. §3313. There may be risks associated with using a non-Delaware adviser if the powers of the adviser are significant and a non-Delaware court obtains jurisdiction over the adviser.

²⁵ 12 Del. C. §3570(9)c.2.-3.

²⁶ 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 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 a practitioner 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.

²⁷ 12 Del. C. §3570(9)d.

use assets (i.e., avoid any retained control arguments which could arise through personal use).²⁸ In addition, the assets should not be situated in a state in which a local court could exercise in rem jurisdiction over such assets. It is recommended, if possible, to transfer the location of the property to Delaware to reduce jurisdictional arguments. The assets used to fund the Trust should be no more than a fraction (perhaps 1/3) of a client's overall assets so as to reduce any implied retained control arguments. If a completed gift is contemplated, highly appreciating assets should be considered if possible. Finally, it is recommended to fund the Trust in a single transaction as opposed to over a period of years.

Limited liability companies (or limited partnerships) are often used in connection with asset protection planning. The use of a limited liability company ("LLC") may also be integrated with the use of a Delaware Asset Protection Trust. For instance, a client may contribute marketable securities to an LLC and then fund the Asset Protection Trust with the LLC interest or, alternatively, the trustee of the Trust might form a single member LLC after the client has contributed the marketable securities to the LLC. The concept is that if a creditor were to be successful in defeating the transfer to the Trust, the creditor would merely become an assignee of the LLC. The effectiveness of a single-member LLC for creditor protection purposes is questionable, especially in light of a bankruptcy court's decision in *In re Ashley Albright*.²⁹ The court in *Albright* rejected the debtor's position that the trustee was limited to the exclusive remedy of a charging order (as prescribed by Colorado law) and held that the trustee was permitted to take possession and control of the single member LLC and authorized the trustee to use the assets of the LLC to satisfy the debtor's creditors. Accordingly, it is often suggested that clients add additional members to the LLC and be certain that such members have some substantive rights under the operating agreement to increase the chances that the arrangement will be respected for creditor protection purposes.³⁰ Finally, we do not suggest that the transferor serve as a managing member

of an LLC (or a general partner of a limited partnership) due to the bankruptcy-related risks discussed above.

It is imperative that the actual transfer of the assets takes place after the creation of the Asset Protection Trust. The funding should be properly documented to avoid any argument that in fact the assets were not timely and correctly transferred to the Trust.

Distribution Provisions

The drafting of the distribution provisions for the transferor during his or her lifetime present several considerations, which are often dependent on whether the client's intent is to have made a completed gift for federal gift tax purposes.³¹ The estate and gift tax implications are discussed in more detail below. The drafting considerations may also depend on whether or not asset protection is of more importance to the client than tax planning or vice versa.

The general principles of drafting any type of trust where the intent is to prohibit a creditor of the beneficiary from accessing the trust assets should be taken into account when drafting a Delaware Asset Protection Trust.

One consideration is to name beneficiaries in addition to the transferor. The fact that there are others who may have a beneficial interest in the Trust (and

tion that the trustee succeeded to a member's interest in a limited liability company and (ii) an order dissolving and liquidating the LLC based on alleged waste or diversion of its assets, the court held that an operating agreement for a limited liability company was not an executory contract and that, as such, the bankrupt member's interest in the limited liability company became property of the bankruptcy estate, notwithstanding any language in the agreement otherwise restricting or conditioning the transfer of the member's interest. The court further provided that the language in the operating agreement that precluded any assignee of a member's interest from participating in the management of the LLC and limiting an assignee to rights to receive distributions that the debtor member would otherwise have received were not applicable to limit trustee's rights and powers with respect to debtor/member's interest in the LLC. It is interesting to note that the debtor was a member of a multiple member LLC and that the court, even though only ruling on a motion to dismiss, concluded that all the limitations in the operating agreement, and all the provisions of Arizona law governing the agreement, constitute conditions and restrictions upon the member's transfer of his interests which are rendered inapplicable by §541(c)(1) of the Bankruptcy Code. The court stated "This necessarily implies the trustee has all the rights and powers with respect to (the LLC) that the debtor held as of the commencement of the case." This case is troubling not only from an asset protection standpoint but also from the perspective of advising any client in connection with business planning.

³¹ As with any trust agreement, it is essential that the distribution provisions on the death of the transferor be consistent with his or her other estate planning documents and that the tax payment provisions be coordinated accordingly.

²⁸ Careful attention is required when transferring stock of a corporation which has elected to be treated as an S corporation for federal income tax purposes. The decision to transfer such stock will be directly related to how the Trust will be taxed for federal income tax purposes (i.e., grantor vs. non-grantor trust) or whether the distribution provisions allow for the Trust to be treated as a qualified subchapter S shareholder.

²⁹ 2003 Bankr. LEXIS 291 (Bkrptcy. Colo. Case No 01-11367 ABC, 4-4-2003).

³⁰ But see *In re Gregory Leo Ehmann et al v. Fiesta Investments, LLC*, 2005 WL 78921 (Bkrptcy. Ariz. Case No. 2-00-05708-KJH, 1-13-2005), where, on a motion to dismiss an adversary proceeding filed by a Chapter 7 trustee for (i) a determina-

thus will have an adverse interest to the transferor) substantially reduces the argument that the transferor has an interest which is attachable by creditors. Including other persons who may have an adverse interest to the transferor raises the possibility that such other beneficiaries may object to the trustee's decision to make distributions to the transferor. Moreover, the argument that there is an implied agreement between the transferor and trustee that the trustee will make distributions to the transferor on demand is significantly reduced. The problem is that a client may not wish to add additional beneficiaries for fear that a trustee may be compelled to make a distribution to such beneficiaries. One alternative is to provide for a different standard of invasion for such beneficiaries (i.e., taking into consideration other sources of funds available to such beneficiaries or subject to an ascertainable standard). On the other hand, if the rights of the other beneficiaries are deemed to be insignificant, the benefits of adding such beneficiaries may be diminished. The practitioner needs to perform a careful analysis (and balancing act) of adding flexibility for the trustee to make distributions to beneficiaries other than the transferor versus providing such beneficiaries with vested rights in the Trust. Another option (as discussed below) may be to provide the client with the power to veto distributions to such beneficiaries.

Another consideration is to provide, when possible, for discretionary distribution provisions for income or principal as opposed to mandatory distribution provisions. It is also suggested not to use an ascertainable standard. In both instances, the reason is that, if the transferor has an enforceable right to receive distributions, so may a creditor.

A third consideration is that you may wish to consider allowing the trustee to suspend distributions to the beneficiary in the event certain situations arise. We would not recommend that the specific event be an impending creditor but rather, draft the Trust in such a manner that in the event the distributions would not benefit the beneficiary in the manner intended, that the distributions of income or principal could be suspended by the trustee for a period of time.

It is important to provide as much flexibility as possible in drafting an Asset Protection Trust so that changes in the Act or tax law may be taken into account by the trustee in administering the Trust. For example, allowing the trustee to subdivide the Trust into two or more sub-trusts with one sub-trust including the transferor as a beneficiary and the other excluding the transferor may be advisable.

Although not expressly prohibited by the Act, we recommend against drafting a joint Asset Protection Trust. The primary reason is that in the event the validity of the Trust is successfully defeated, there is a risk that a creditor of one of the transferors may attempt to reach the assets of both transferors.

Retained Powers by Transferor

The Act provides that, subject to several exceptions, a transferor shall have no rights or authority with respect to the property that is the subject of a qualified disposition or the income therefrom. Thus, a transferor may not retain the power to serve as trustee, the power to direct distributions from the Trust or to demand a return of assets transferred to the Trust.³² Nevertheless, there are a variety of powers that a transferor is permitted to retain under the Act.³³ The question is whether it is advisable for the transferor to retain such permitted powers and what are the consequences thereof.

The Act provides that a transferor is permitted to retain the power to veto a distribution from the Trust. This provision is often included to ensure that the transfer to the Trust is incomplete for federal gift tax purposes. This provision may also provide a transferor with a level of comfort in including additional discretionary beneficiaries during the initial term of the Trust. If a practitioner believes that creditor protection benefits are afforded through the use of additional beneficiaries (as discussed above), a question would arise as to whether or not a court would ignore such additional beneficiaries if such a veto power were to be retained by the transferor. Finally, this provision should not be used if non-grantor trust status is intended.

The Act permits a transferor to retain a limited testamentary power of appointment. As discussed below, this provision is often used to make the transfer to the Trust incomplete for federal gift tax purposes.

The Act permits the transferor to retain the right to receive discretionary distributions of income or principal, current income distributions, payments from a charitable remainder trust, annual payments of up to 5% of the value of the trust, or principal distributions under an ascertainable standard.³⁴ Such powers have estate and income tax implications that must be considered. The transferor may also retain the right to the use of real property held under a qualified personal residence trust as defined in §2702(c) of the Internal Revenue Code of 1986, as amended (the "Code").³⁵

Finally, the Act permits a transferor to remove and replace a trustee or adviser so long as the new trustee or adviser is not a related or subordinate party within the meaning of §672(c) of the Code. There exists a potential risk, however, with including such a power.

³² 12 Del. C. §3570(9)c. and 12 Del. C. §3571.

³³ 12 Del. C. §3570(10)b.1.-8.

³⁴ 12 Del. C. §3570(10).

³⁵ *Id.*

Specifically, under §541 of the Bankruptcy Code,³⁶ the bankruptcy estate includes all legal and equitable interests of the debtor. Thus, arguably, if a transferor had the power to remove and replace a trustee then the bankruptcy trustee would also have such a power. It seems likely that a bankruptcy trustee would be able to find a successor trustee willing to make distributions to the debtor's estate. The ability to remove and replace a trustee could also give the appearance of too much control by the transferor. In other words, a Court may be convinced that a transferor could continue to remove and replace a trustee until he or she locates a trustee willing to make a discretionary distribution even though the successor trustee may not be a related or subordinate party. Given these potential risks, it is generally advisable not to grant a transferor the power to remove and replace a trustee.³⁷

Federal Income Tax Considerations

In drafting a Delaware Asset Protection Trust, another important consideration is whether the Trust should be drafted as a grantor or non-grantor trust for federal income tax purposes and how to draft the Trust accordingly.³⁸ While much has been written on the subject of grantor trust status,³⁹ we will just briefly mention some of the issues relevant to Delaware Asset Protection Trusts.

If the Trust has been drafted as a completed gift for federal gift tax purposes, it may make sense for the Trust to be a grantor trust. The reason is that the Trust is 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).⁴⁰ This decision, however, depends on the client's ability to pay the income taxes from assets outside of the Trust. If the transferor has insufficient assets to pay the income taxes, non-grantor trust status may be the preferable recommendation as care should be taken to avoid distributions on a regular or established basis (i.e., the risk of an "implied understanding" argument). 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.

There may also be state income tax issues to consider. If the Trust is a non-grantor trust, Delaware law

provides that state income tax is not imposed on trust income (including capital gains) accumulated for out of state remainder beneficiaries.⁴¹ In certain states with high income tax rates, this can provide a significant tax savings.

Given the typical provisions of a Delaware Asset Protection Trust, grantor trust status will generally occur. Specifically, the Trustor's retained rights to discretionary distributions of income and principal should be sufficient to obtain grantor trust status under §677(a) of the Code.⁴² In addition, the general rule under §674(a) of the Code is that the grantor will be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the principal or income is subject to a power of disposition exercisable by the grantor without the approval or consent of an adverse party.

The more difficult question is how to draft an Asset Protection Trust as a non-grantor trust.⁴³ The most common approach used to obtain non-grantor status is through the use of an adverse party⁴⁴ to consent to distributions to the transferor. As mentioned above, the consent of an adverse party is a general exception to §§674 and 677 of the Code. Thus, the trust would provide that any distributions to the transferor would be subject to the consent of one or more of the beneficiaries. The transferor may be reluctant to provide this restriction on his or her right to receive discretionary distributions of income and principal as he or she may view this as a significant loss of control. One way to mitigate this concern may be to provide that only one adverse party need consent to the distribution. This assumes that at least one of the beneficiaries would provide the desired consent. Practitioners often use a distribution committee consisting of adverse parties.

As mentioned above, a testamentary limited power of appointment is often used to ensure that contributions to the Trust are considered incomplete gifts. However, such a limited power of appointment constitutes an ability to affect the beneficial enjoyment of property under §674(a) of the Code (i.e., grantor trust

³⁶ U.S. Code, Title 11.

³⁷ As mentioned above, it may be questionable to permit an adviser to remove and replace a trustee if the adviser can in turn be removed and replaced by a transferor.

³⁸ See §§671 through 679 of the Internal Revenue Code.

³⁹ See Zaritsky, 858-2nd T.M., *Grantor Trusts: Sections 671 - 679*, Irizarry-Diaz, "How Defective is Your Trust? Suggestions on Structuring an Intentionally Defective Grantor Trust," 41 *Tax Mgmt. Memo.* No. 13, 231 (6/19/2000), and Esperti and Peterson, *Irrevocable Trusts* (Chapter 4).

⁴⁰ Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

⁴¹ 30 Del. C. §1636.

⁴² Section 677(a) provides, in part, that a grantor will be treated as the owner of any portion of a trust if the income, without the consent of an adverse party, may be distributed (or held or accumulated for future distribution) to the grantor.

⁴³ In PLRs 200148028 and 200247013, the Internal Revenue Service determined that the Delaware asset protection trusts in question were non-grantor trusts. These rulings provide a useful roadmap for drafting a non-grantor trust. See also, PLR 200502014.

⁴⁴ An adverse party is defined under §672(a) of the Code to mean any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust.

status results). Section 674(b)(3) of the Code provides for an exception to the grantor trust rule if the power is exercisable only by Will. This exception does not apply, however, if income is accumulated during the transferor's lifetime and the power is exercisable without the consent of an adverse party.⁴⁵ Thus, the consent of an adverse party should be used to accumulate income.⁴⁶ A question may also arise if the transferor retains the right to veto distributions of income. This power could arguably permit a transferor to force the accumulation of income, which combined with a testamentary limited power of appointment could cause grantor trust status.

Federal Estate, Gift and GST Tax Considerations

Many commentators have addressed the gift, estate and generation-skipping transfer tax considerations of the Asset Protection Trust.⁴⁷ Rather than pursuing a discussion as to whether a Trust may be drafted to be a completed or non-completed gift or whether the Trust will or will not be excluded from a transferor's estate for federal estate tax purposes, we address some practical considerations on these topics and how to draft the Trust accordingly.

The Regulations provide, and the Internal Revenue Service has ruled, that a grantor's retention of a special testamentary power of appointment will prevent him or her from making a completed gift for federal gift tax purposes unless distributions are actually made.⁴⁸

In determining whether to make a transfer to an Asset Protection Trust a completed gift for federal gift tax purposes, the practitioner must determine whether the transferor has any reasonable expectation of requiring distributions in the future. Obviously, one would not want to draft an Asset Protection Trust so that the transfers to the Trust are completed gifts if the transferor believes that he or she ultimately will need to seek distributions from the Trust (i.e., a waste of

lifetime exemption). On the other hand, if a client does not expect to receive distributions from the Trust or is considering transferring assets that have a likelihood of substantially increasing in value, than a completed gift for federal transfer tax purposes may be appropriate.⁴⁹ In this event, the transferor should timely file a federal gift tax return setting forth in detail the transfer so that the appropriate statute of limitations begins to run. Once the statute of limitations expires for assessment of gift tax, then the transfer should only be subject to inclusion in the transferor's gross estate for federal estate tax purposes to the extent that a completed gift would be included.⁵⁰

The Internal Revenue Service has declined to rule on whether an Asset Protection Trust would be includible in a transferor's estate for federal estate tax purposes.⁵¹ It seems the Service is reluctant to make such a ruling if the facts and circumstances appear as though the transferor retained control of the transferred assets. We are unaware of any specific authority addressing the inclusion or exclusion of the Asset Protection Trust from a decedent's estate for federal estate tax purposes. There certainly is authority to support the argument that, if properly drafted, an Asset Protection Trust may be excluded from a transferor's estate for federal estate tax purposes.⁵²

The generation-skipping transfer tax considerations are more directly tied to the analysis of whether the gift should be a completed gift for federal gift tax purposes. Once again, it generally does not make sense to allocate generation-skipping transfer tax exemption (or draft a Trust with generation-skipping transfer tax provisions) to transfers for which there is a likelihood that the transferred assets would be reconveyed to the transferor. Since there are no cases that have upheld the effectiveness of the Asset Protection Trust (for both creditor protection purposes and estate tax purposes), careful practitioners may wish to take a wait and see approach on the ultimate effectiveness of the Asset Protection Trust before recommending allocations of generation-skipping transfer tax exemption to these transfers.⁵³

⁴⁵ Regs. §1.674(b)-1(b)(3). This regulation goes so far as to indicate that if a trust instrument provides that the income is payable to another person for life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are to be added to corpus, the grantor is treated as the owner of such portion of the trust.

⁴⁶ It would seem logical that, if an adverse party must consent to a distribution of income, this would imply that the accumulation would indirectly also be subject to consent of the adverse party. However, it appears that the more conservative drafting approach is to clarify that the accumulation *and* distribution of income must be with the consent of an adverse party.

⁴⁷ See footnote 1.

⁴⁸ Regs. §25.2511-2(b). See PLRs 200247013, 200148028 and 200502014.

⁴⁹ Of course, the powers retained by the transferor must be reviewed under §§2036 and 2038 of the Code.

⁵⁰ Regs. §301.6501(c)-1(f)(5).

⁵¹ PLR 9837007.

⁵² See footnote 1.

⁵³ A transferor's allocation of generation-skipping transfer tax exemption to transfers to an Asset Protection Trust will not be effective as long as the Trust is subject to an estate tax inclusion period. Regs. §26.2632-1(c).

CONCLUSION

In addition to the legal and tax implications of a Delaware Asset Protection Trust, there are many practical issues that a practitioner must take into consideration when drafting such a Trust. Once the practitioner has completed the due diligence process and clearly explained the benefits and risks of the Delaware Asset Protection Trust to the client, many decisions must be made concerning the terms of the Trust, including, but not limited to, the choice of the trustee, the distribution provisions, how the Trust will be

taxed for federal and state income tax purposes, whether the Trust will be a completed gift (and if so, whether generation-skipping transfer tax exemption will be allocated), the proper assets to select in funding the Trust, and which powers the trustor intends to retain over the Trust. Each of these decisions requires careful analysis and review with the client to be certain that the Trust not only complies with the Act but also comports with the client's overall intent by taking into account the practical considerations involved in the drafting of any estate planning document.