THE NORTHERN TRUST INSTITUTE

WEALTH MANAGEMENT

DELAWARE TRUSTS

Safeguarding Personal Wealth

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DELAWARE TRUSTS: SAFEGUARDING PERSONAL WEALTH

The State of Delaware has established itself as a favorable jurisdiction for personal trusts due to its modern laws, tax savings and investment flexibility, among other reasons. This piece highlights the most significant legal and tax benefits of a Delaware trust — for both residents and nonresidents alike — along with strategies to help clients protect and preserve their wealth for generations to come.

The Northern Trust Institute brings the breadth and depth of the firm to address the increasingly complex and sophisticated wealth management needs of our clients and their advisors. Informed by the latest insights and continually vetted through feedback, our advice is grounded in real-world outcomes and backed by proven credibility.

We believe you will find this information helpful and look forward to collaborating with you to create meaningful legacies for our clients.

TRUSTS IN DELAWARE — AT A GLANCE

The following are highlights of topics covered in this year's edition.

Can you direct a trustee on investments in Delaware?

Delaware has a "directed trust" statute that permits a trustee to be directed on investments, distributions and other matters. The statute also creates the role of a trust protector. Directed trusts are discussed beginning on page 6.

Are Delaware trusts subject to income tax?

Although Delaware does have an income tax on trusts, there is an offset for non-Delaware beneficiaries. Thus, if a Delaware trust does not have any beneficiaries in Delaware, there is no Delaware income tax on the trust. They are still subject to federal income tax if they are not grantor trusts for income tax purposes. Also, even if a trust is not subject to Delaware income tax, it may be subject to income tax by another state depending on the fact pattern of the trust. Income taxation of Delaware trusts is discussed beginning on page 11.

Does Delaware allow long-term or "dynasty" trusts?

Delaware allows personal property to be held in trust for an indefinite period. Real estate can be held for 110 years, but if the real estate is held in an entity such as an LLC, it can be held for an indefinite period. Thus, a dynasty trust can be created in Delaware. These trusts can be useful in long-term wealth transfer planning. The ability to have a long-term trust in Delaware is discussed beginning on page 9.

Are "quiet trusts" permissible in Delaware?

Trusts known as "quiet trusts," "silent trusts" or sometimes "confidential trusts" are permitted in Delaware. The ability to have a "designated representative" receive statements and have knowledge of the trust on behalf of beneficiaries is permitted. Confidential trusts are discussed beginning on page 12.

If needed, is it possible to modify a Delaware trust?

Delaware has various methods for modifying irrevocable trusts. These methods include decanting, merger and nonjudicial modification agreements. There are various factors that go into deciding whether it is necessary to modify a trust. The topic of trust modifications of Delaware trusts is discussed beginning on page 15.

Does Delaware permit electronic execution of trusts?

Delaware permits electronic execution of trusts. This is discussed beginning on page 20.

Are there other flexible provisions of Delaware law?

This paper covers the above topics plus several other provisions of Delaware law. Delaware provides a progressive and flexible environment in which to establish a trust.

FIGURE 1: KEY MILESTONES OF DELAWARE TRUST LAW

Year	Milestone
1971	Creation of deduction for trust income accumulated in irrevocable trusts for future distribution to nonresident beneficiaries
1986	Formal recognition of administrative trusts or directed trusts
1995	Repeal of the Rule Against Perpetuities
1997	Adoption of a self-settled spendthrift trust statute
2000	Enactment of the nation's first total return unitrust statute
2005	Ability for a grantor, by express direction in the trust instrument, to maintain confidentiality for a designated period of time
2007	Expansion of virtual representation rules, which simplified the process of obtaining consent to trust petitions filed with the court
2013	Enactment of Nonjudicial Settlement Agreement (NJSA) statute
2014	Addition of inter vivos limited power of appointment to asset protection trusts
2015	Liberalization of trust merger rules
2016	Addition of trust modification statute when grantor is still living
2017	Creation of co-trustee/excluded trustee structure plus amendment of decanting statute to allow the "second trust" to be the first trust as modified by the decanting
2018	Further expansion of virtual representation rules; reducing the time period to one year to bring a claim against a trustee; broadening various provisions of the statute to include non-fiduciaries and persons other than beneficiaries
2019	Ability to allocate duties among successor and additional trustees by use of trustee appointment document
2020	Clarification to various statutes including those addressing nonjudicial modifications, and the ability to allocate duties among successor and additional trustees by use of trustee appointment document
2021	Enactment of electronic signature provisions, and expansion of the designated representative statute
2022	Clarification to various statutes including those addressing notice provisions, the ability to release beneficial interests, and the period of limitations for bringing a claim against a trustee

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INNOVATIVE LEGISLATIVE AND JUDICIAL INFRASTRUCTURE

Delaware has long been home to substantial personal wealth, including long-term trusts funded by local residents. Delaware began to attract wider attention as a trust jurisdiction in 1986 when its General Assembly completed a massive overhaul of its trust laws. Although Delaware had earlier granted a deduction for trust income of trusts held for nonresident beneficiaries, the 1986 revision began the formal recognition of so-called administrative trusts or directed trusts. The repeal of the rule against perpetuities in 1995, the adoption of a self-settled spendthrift trust statute in 1997, and the enactment of the nation's first total return unitrust statute in 2000 firmly established Delaware's reputation as an innovative jurisdiction for safeguarding personal wealth. Significant changes continue to be enacted with Delaware's Trust Act each year.

While the advances in trust law have been significant, an equally important benefit is the exclusive jurisdiction of the Delaware Court of Chancery over matters of equity, which generally covers all fiduciary proceedings and disputes (other than the rare case involving a non-fiduciary claim for monetary damages against a trust or a trustee). With an established body of fiduciary law and a bench of highly experienced jurists, the Court of Chancery offers lawyers and their clients the assurance that, should a trust dispute ever arise, Delaware has the judicial infrastructure to resolve it efficiently and fairly.

INVESTMENT FLEXIBILITY

When the General Assembly crafted its revisions to Delaware's trust laws in 1986, the most remarkable change was the adoption of a modern portfolio approach to trust investing. Although the prudent investor rule has now been adopted in nearly every state, Delaware's enactment seemed almost revolutionary at the time. The new principle, codified at 12 *Del. C.* § 3302(b), allowed trustees to depart from the traditional rule of ensuring that each and every investment was both safe and productive.[1] Rather, § 3302(b) permits trustees to acquire assets of virtually any nature because their investment performance is judged on the basis of the entire portfolio. Thus, trustees can invest in a manner that has the potential to generate higher returns through investments in growth stocks, emerging markets and alternative investments as long as the portfolio as a whole was invested in a manner that a prudent investor would adopt.

Furthermore, 12 *Del. C.* § 3303 allows a grantor to limit a trustee's liability to willful misconduct for not diversifying trust assets if the language of the trust agreement directs the trustee not to diversify, or specifies the circumstances in which the assets are to remain undiversified. The statute specifically provides that "the rule that statutes in derogation of the common law are to be strictly construed shall have no application to this section. It is the policy of this section to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments."[2]

Absent specific language in the trust agreement, under Delaware law, trustees have a general duty to exercise prudence in managing a concentrated position, a duty that often requires a trustee to reduce the position despite family opposition. A 2009 decision of the Delaware Court of Chancery, *Merrill Lynch Trust Co., FSB. v. Campbell,*[3] reaffirmed the critical role of a trust agreement in determining the limits on a trustee's liability for a trust's poor investment performance. In that decision the court held that the trust instrument provided for a large payout and long duration, making the trustee's investment choices seem reasonable under the circumstances.

Environmental, Social and Governance (ESG) Investing

Delaware has also recognized the growing interest by beneficiaries in investing in holdings that promote ESG goals. The Delaware statute recognizes this with the following language:

> *"... when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries."[4] The statute also provides that the trust instrument may expand the laws of general application to fiduciaries including laws pertaining to, "the manner in which a fiduciary should invest assets, including whether to engage in one or more sustainable or socially responsible investment strategies, in addition to, or in place of, other investment strategies with or without regard to investment performance."[5]*

DIRECTED TRUSTS

Much of the wealth that funds trusts comes from grantors who are still in the wealth creation stage. Typically they have generated their wealth by having significant control over their assets or business. The desire for retaining some level of control has ushered in the growth of directed trusts. As of the date of this edition, more than 40 states have some form of statute that allows a trustee to be directed on matters such as investments, distributions, tax compliance or perhaps a combination of some or all of these functions. The trend

continues with the promulgation of the Uniform Directed Trust Act by the Uniform Law Commission in 2017.[6] So far at least 16 states have enacted or introduced this uniform act, which evidences that the trend toward directed trusts is becoming more customary.

In 1986 Delaware was the first state to formally recognize directed trusts by statute, with the enactment of 12 *Del. C.* § 3313 which is often referred to as Delaware's directed trust statute. Even before the enactment of this statute, directed trusts existed in Delaware dating back to the early 1900s based on trust instruments directing the trustee to hold a concentrated position of stock. This was due to the large number of trusts created by members of the DuPont family that held concentrated positions of DuPont stock.

A trustee can be directed on any matter including investments, distributions and tax matters. The unique nature of Delaware's law on directed trusts has led to a substantial influx of trusts in which some party other than the trustee has exclusive responsibility for the investment of some or all of the trust assets. A common use of the statute is to permit the grantor to fund a trust with an asset such as a closely held company, or any other asset that a corporate trustee might not hold unless directed. Specifically, 12 *Del. C.* § 3313(b) authorizes the trustee to take direction from an advisor named in a trust instrument, without liability for the advisors' investment results, except in the event of the trustee's willful misconduct.[7] With the bifurcation of the trustee's traditional duties of administration and investment management, the advisor is treated as a fiduciary for the investment component, absent language in the trust agreement stating that the advisor is not a fiduciary. The most common practice is that the advisor serves in a fiduciary role.

It is this protection from liability for the trustee, except in cases of willful misconduct by the trustee, that enables trustees to hold trust assets that the grantor wants the trust to hold, which the trustee might not be able to do otherwise. Thus, the statute ultimately provides a benefit to the trust beneficiaries.

To bolster a directed trustee's protection from liability for the conduct of an advisor, 12 *Del. C.* § 3313(e) explicitly absolves a directed trustee of a duty to monitor the conduct of the advisor, provide advice to the advisor, or consult with the advisor, or communicate with or warn or apprise any beneficiary or third party concerning instances in which the trustee would have exercised thier own discretion in a manner different from the manner directed by the advisor. Actions of the trustee that are seemingly within the scope of the advisor's duties (such as confirming that the advisor's directions have been implemented) are presumed to be administrative in nature and not an undertaking of the trustee to become a co-advisor.

The extent of a directed trustee's protection from liability under 12 *Del. C.* § 3313(b) was the subject of the dispute in *Duemler v. Wilmington Trust Co.*, in which the co-trustee and investment advisor brought an action against an administrative trustee for losses the trust incurred after the investment advisor elected not to tender a bond in an exchange offer and the bond issuer subsequently defaulted on its obligation.[8] The investment advisor claimed that the trustee wrongly failed to deliver to him a copy of the prospectus for the exchange offer. In concluding that 3313(b) insulated the directed trustee from liability, the vice chancellor observed:

> *In connection with Plaintiff's decision not to tender the securities in the Exchange Offer, [the trustee] acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer.*[9]

Note that 12 *Del. C.* § 3313 makes it clear that the statutory protection is also available when a trustee is directed not to take specified actions unless directed. The statute also specifies that the definition of "investment decision" includes powers commonly understood to be part of investment decisions but which were not specifically covered in the statute previously. This includes matters such as the power to lend and borrow for investment purposes, the power to vote, and various powers and activities that are generally part of investment decisions. Thus, it is clear that a trustee can be directed in these matters and be protected by the statute.

At times the question arises in the administration of a trust as to whether a loan to a beneficiary falls within the discretion of the trustee or is under the purview of the advisor directing the trustee. Subsection (d) of the statute clarifies that "investment decisions," which would fall under the purview of an advisor directing a trustee on investments, do not include loans that are made in lieu of a distribution to a beneficiary that could have been made to or for the benefit of a beneficiary.

As illustrated below, the directed trust statute has provided a useful solution to a number of common trust problems.

CLIENT SITUATION:	POTENTIAL SOLUTION:
Concentrated position A trustee of a trust with a concentrated position in a particular asset may want to sell a substantial portion of the asset to achieve greater diversification and reduce the concentration risk. The beneficiaries may oppose a sale because of their emotional attachment to the asset or simply the belief that the asset will perform well over the long term.	**Family committee manages concentration** To resolve this familiar conflict, the parties can seek to modify the trust into an administrative trust in which a family committee (composed of family members who are experienced professionals) has exclusive investment responsibility for the concentrated asset, while the trustee retains management authority over the more diversified assets.
Funding with closely held assets A client wants to contribute to a family trust certain interests in a closely held operating business or investment entity, but the client is uncomfortable with the notion that the trustee would have investment responsibility for the closely held asset.	**Client retains control** If the client designates himself or herself as the investment advisor for the closely held asset, the trustee will not have any authority to participate in decisions regarding the client's business or investment entity.

As noted above, § 3313 also applies to "distribution decisions or other decisions of the fiduciary" and is not limited to investment decisions. For example, the appointment of a distribution advisor in a trust agreement may be especially useful if the grantor wants to impose "lifestyle" standards or other subjective criteria for the beneficiaries' eligibility (or ineligibility) to distributions of income and principal of the trust. These sorts of standards may be difficult for corporate trustees to apply if they lack intimate knowledge of the beneficiaries' lifestyles and it is impracticable to gather the information on which to base a distribution decision. If a grantor feels strongly about incorporating subjective standards into their trust agreement, it may make sense to appoint a family member, a family confidant, or even a professional individual fiduciary to make potentially controversial judgments about the beneficiary's lifestyle, moral character or productivity.

Furthermore, § 3313(f) allows a directed trustee to follow the direction of a trust protector without concern for liability stemming from the protector's actions. The trust protector can take a wide variety of actions, including the exercise of removal and appointment powers, the modification or amendment of a trust instrument to achieve a favorable tax result or improve the trust's administration, and the modification of a beneficiary's power of appointment under the governing instrument.

Excluded Trustees

Delaware's Excluded Trustee statute, 12 *Del. C.* § 3313A, goes beyond the concept of a directed trust and creates a complete division of responsibility among parties. In a directed trust, the advisor will direct the trustee, and the trustee enjoys limited liability. However, in an excluded trustee relationship under § 3313A, a trust will have a trustee and an "excluded trustee."

The excluded trustee does not take direction from the advisor. Rather, each trustee has their own sphere of responsibility.

Section 3313A provides that the excluded trustee is not liable (individually or as a fiduciary) for any loss resulting directly or indirectly from the action taken by the other trustee, as long as the trust agreement gives that other trustee exclusive authority over the matter in question. Specifically, the statute provides that "the co-trustee holding the power to take certain actions with respect to the trust shall be liable to the beneficiaries with respect to the exercise of the power as if the excluded trustee were not in office and shall have the exclusive obligation to account to the beneficiaries and defend any action brought by the beneficiaries with respect to the exercise of the power."[10] This statute also provides that the trust instrument may enable the trustee with the responsibility over the matter to direct the excluded trustee if needed. This is useful when the excluded trustee has custody of the assets, which is common when a corporate trustee is the excluded trustee, and the excluded trustee needs to be directed to deliver the assets as part of the other trustee selling the assets, receive the assets upon purchase, or other similar administrative actions.

Subsection (a)(2) of § 3313A provides that although the excluded trustee is not a fiduciary for any power that falls to the co-trustee, the excluded trustee remains a fiduciary with respect to any powers or other matters over which the other trustee does not have exclusive authority under the terms of the trust.

THE RULE AGAINST PERPETUITIES

Prior to the latter part of the 20th century, every state had adopted, in one form or another, the rule against perpetuities (the Rule), which has the effect of limiting the duration of a trust. Under the traditional common law Rule, if an interest must vest at all, it must vest within 21 years after the death of all identified individuals living at the creation of the trust. The Rule reflects a policy judgment that property owners should not be permitted to restrict the transfer of their property beyond the lives of persons who were likely known to the owner plus the minority period of the next generation. The practical effect of the rule against perpetuities was that trusts could last only a few generations, after which the remainder interests would have to be distributed outright to the class of remainder beneficiaries.

The complexity of applying the Rule caused a number of states to develop alternatives to the common law Rule, such as the 90-year period under the Uniform Statutory Rule Against Perpetuities. But, it was not until the Tax Reform Act of 1986 (the 1986 Act) that states began to seriously consider abolishing the Rule outright. This is because the 1986 Act re-introduced the transfer tax on generation-skipping transfers (the GST tax). Congress intended the GST tax to apply to transfers that skipped the next immediate generation and would otherwise avoid an estate tax at that intermediate generation.[11] The 1986 Act provided each transferor with a lifetime exemption from the GST tax. Under the Tax Cuts and Jobs Act of 2017 (TCJA), the basic exclusion amount for 2023 is $12.92 million and indexed for inflation for subsequent years.[12] Note that under the TCJA, on December 31, 2025, this basic exclusion amount is set to return to the lower amount of $5 million that existed prior to 2018. Importantly, the Internal Revenue Code (the IRC) does not place any limit on the duration of a transferor's GST exemption or the duration of corresponding GST-exempt trusts. Thus, if the limit on the length of a GST-exempt trust were the applicable rule against perpetuities, an extension or outright abolition of the Rule would vastly increase the number of generations who could enjoy the fruits of the transferor's GST-exempt trust, without diminution of the trust assets on account of any federal transfer tax.

1995 REPEAL

In 1995, Delaware became the first state after the passage of the 1986 Act to repeal its rule against perpetuities, thus permitting trusts of personal property to last potentially forever.[13] Although direct interests in real property remain subject to a perpetuities period of 110 years, a Delaware trust may be able to hold real property without limitation if the property is held through a corporation, limited partnership, limited liability company or other entity.[14]

In the ensuing years, many states have adopted legislation that either allows a trust agreement to opt out of the Rule, extends the Rule to a finite period, or repeals the Rule altogether.

The economic benefit of a long-term GST-exempt trust can hardly be denied. As Figure 2 demonstrates, a client's ability to contribute assets to a trust that will continue for generation after generation without the imposition of any transfer tax is an extraordinary opportunity when compared to the alternative of passing assets outright, from generation to generation, subject to a federal transfer tax at each generation. Assuming a $12.92 million contribution to a trust, a five percent after-tax rate of return on the investment assets, a new generation every 25 years, and a federal estate tax of 40 percent applied at each generational transfer, the GST-exempt trust would have a value of $501,718,302 after only 75 years. The same sum of $12.92 million held outside of a trust (and subject to a gift tax or estate tax upon transmittal to each successive generation) would have a value of $108,371,153. (See Figure 2.)

With the passage of each generation, the difference in value between the GST-exempt trust and the "no-trust" alternative becomes exponentially larger. With such a compelling financial outcome, it is not surprising that Delaware fiduciaries have witnessed an influx of long-term or "dynasty" trusts.[15]

Common funding examples of Delaware dynasty trusts include the following:

- A grantor contributes cash, marketable securities or interests in a closely held entity (in the latter case, often at discounted values) to an irrevocable trust, using the grantor's lifetime applicable gift tax exclusion ($12.92 million in 2023). The grantor then allocates a portion of their lifetime GST exemption (also $12.92 million in 2023). Trust beneficiaries will benefit from the trust for years to come.

- A grantor sells assets to a trust on the hope that the assets will appreciate. The trust that purchases the assets is an irrevocable trust that is "defective" for income tax purposes, meaning that it includes powers that will cause it to be treated as a grantor trust. The grantor contributes seed money to the trust in order to collateralize the trust's purchase of the assets, and the grantor may use some of their lifetime gift tax exclusion in order to avoid making a taxable gift to the trust. The trust then purchases the appreciating assets from the grantor in exchange for a promissory note that is collateralized by the seed money. The promissory note will bear interest at the appropriate applicable federal rate, which is a minimum rate of interest set by the IRS (the AFR). If the rate of return on the purchased assets exceeds the interest rate on the promissory note (i.e., the hurdle rate), then the grantor will have successfully transferred the appreciated value of the asset out of their estate and to the beneficiaries for their enjoyment. A trustee of an irrevocable life insurance trust with Crummey powers (with multiple Crummey beneficiaries) acquires a life insurance policy on the life of the grantor (or a joint and survivor policy on the lives of the grantor and the grantor's spouse). The grantor(s) contributes the annual insurance premiums using their annual gift tax exclusions ($17,000 in 2023) or, in the case of a single premium insurance policy, using their lifetime applicable gift tax exclusion ($12.92 million in 2023). Death benefits payable to the trust often will vastly exceed the premium expense, and the insurance proceeds are excludable from the grantor's estate and exempt from GST tax (assuming an allocation of the grantor's GST exemption to the trust).

FIGURE 2:

	DELAWARE DYNASTY TRUST **Transfers in Trust to Next Generation Every 25 Years**	**TAXABLE OUTRIGHT** **Transfers to Next Generation Every 25 Years**
Year 1	$12,920,000	$12,920,000
Year 25 Value	$43,751,706	$43,751,706
Transfer Tax	—	($17,500,682)
Ending Value	$43,751,706	$26,251,024
Year 50 Value	$148,158,805	$88,895,283
Transfer Tax	—	($35,558,113)
Ending Value	$148,158,805	$53,337,170
Year 75 Value	$501,718,302	$180,618,589
Transfer Tax	—	($72,247,436)
Ending Value	$501,718,302	$108,371,153
Delaware Benefit =	$393,347,149	

Assumptions:

1. Federal estate tax rate: 40%
2. Return on investment assets: 5% annually
3. No state income taxes
4. No distributions from trust or consumption of principal or income
5. No basic exclusion amount used to offset taxable amount in future years

SAVINGS ON FIDUCIARY INCOME TAXES

State income taxes can be a significant drag on the growth of an irrevocable trust. In many states, a trust's realized capital gains and accumulated ordinary income are taxed at rates between five and 10 percent, with rates in California as high as 13.3 percent. Thus, in addition to the 20 percent rate on capital gains at the federal level, plus the potential net investment income tax of 3.8 percent, state income taxes can greatly reduce trust earnings.

Delaware offers an appealing alternative venue for irrevocable trusts because it does not impose any state income tax on income that is accumulated for distribution to nonresident beneficiaries in future years.[16] As a practical matter, an irrevocable trust for nonresident beneficiaries should not be subject to any Delaware income tax because its income either will be distributed to its beneficiaries with a corresponding deduction for the distribution,[17] or will be accumulated with a deduction.

As an example of the potential tax savings, if two trusts (one in California and one in Delaware) were to sell a zero-basis asset for net proceeds of $10 million, the after-tax proceeds of the sale in the Delaware trust would potentially be worth $1.33 million more because the proceeds in the California trust would be subject to California income tax at a rate of 13.3 percent. (See Figure 3.)

FIGURE 3:

	Sale in Delaware Trust	Sale in California Trust
Sale Proceeds	$10,000,000	$10,000,000
Tax Cost	$0	$0
Gain on Sale	$10,000,000	$10,000,000
State Income Tax	$0	$1,330,000
Federal Income Tax	$2,330,000	$2,330,000
Proceeds Net of Tax	**$7,670,000**	**$6,340,000**
Delaware Benefit =	$1,330,000	

Assumptions:

1. Federal capital gains rate: 23.8%
2. California state income tax rate: 13.3% (maximum rate of 12.3% plus a mental health services tax of 1% for taxable income over $1,000,000)
3. No federal tax deduction for state taxes paid

Potential "Traps"

For a trust to take full advantage of Delaware's deduction for trust income accumulated for nonresident beneficiaries, it is essential that the trust avoid a tax nexus with another jurisdiction. A number of factors can cause a Delaware trust to become subject to state income tax in another state. For example:

- Many jurisdictions will treat a trust as a resident trust, and subject to state income tax, if the trust has a fiduciary residing in that state, or if the trust administration occurs in that state. For instance, if a Delaware trust has a noncontingent beneficiary, a co-trustee, or investment or distribution advisor located in California, that state could consider the trust to be subject to its tax regime. Similarly, if a Delaware corporate trustee delegates a major portion of their trust administration duties to an affiliate in another state (i.e., the affiliate has full discretion to manage the trust's investment portfolio without any supervision of the Delaware trustee), there is a risk that the affiliate's state would consider the trust to be resident and fully taxable in that state.[18]
- If a Delaware trust has source income from an operating business or real estate located in another state, that state likely will claim that it is entitled to tax at least a proportionate share, if not all, of the trust's federal taxable income.[19] Portfolio managers of Delaware trusts must be aware of investments that could generate source income from a high tax state. Investments like hedge funds and private equity funds often have layers of entities, and managers should be mindful that a fund could allocate state sourced income to a trust on a Form K-1.
- Perhaps most significantly, a considerable number of states will attribute resident status to an irrevocable trust established in another state if the grantor of the trust was a resident of the state when the trust became irrevocable. Examples of states that have adopted this treatment of non-domiciliary trusts — known as the "residence-by-birth" approach — include, but are not limited to, Connecticut, Illinois, the District of Columbia, Michigan, Minnesota, New York, Ohio, Pennsylvania, Virginia and Wisconsin. There may be due process grounds for challenging the constitutionality of residence-by-birth tax schemes under the Supreme Court's decision in *Quill Corp. v. North Dakota*.[20] Following the *Quill* decision, state courts were notably unfriendly to states' attempts to assert taxing jurisdiction, and until recently the Supreme Court had declined to address the issue. Thus, fiduciaries are often left with little guidance

regarding their obligations to pay fiduciary income tax to another state.[21] There have been a number of cases where the state court ruled that the mere fact that the trust was created by a grantor of that state was not sufficient to create a taxable nexus where there were no other connections with the state. These cases include the *McNeil* case in Pennsylvania, the *Linn* case in Illinois and the *Fielding* case in Minnesota. They are notable in part because they were decided in residence-by-birth states.[22] But, because these cases relied on their specific facts, care should be used in relying on these cases. Residents of Pennsylvania, Illinois, Minnesota and other residence-by-birth states should not assume their trusts will be exempt from state income taxes merely because the trust is located in Delaware or another trust-friendly jurisdiction.

Note that the trend of determining taxation to be unconstitutional continues in the more recent Kaestner decision, which came from the North Carolina courts and was ultimately decided in the U.S. Supreme Court in the *Kaestner* case.[23] In this case the U.S. Supreme Court addressed the constitutionality of state taxation of a trust's undistributed income, based solely on a beneficiary living in the state imposing the taxation. North Carolina imposed an income tax on a trust over a four-year period even though the beneficiaries received no income in those tax years, had no right to demand income in those years, and could not count on ever receiving income from the trust. The Court held that this imposition of tax violated the Due Process Clause of the U.S. Constitution.

In 2014, New York State changed the way it might tax a beneficiary of a Delaware trust. Historically, if a Delaware trust created by a New York resident did not have a New York fiduciary, New York source income, or New York real or tangible personal property owned by the trust, New York would not impose fiduciary income tax on the trust. However, under the 2014-15 New York State Budget, which became effective April 1, 2014, distributions to a New York resident beneficiary from a New York resident trust will be subject to a throwback tax on previously undistributed income accumulated during any tax year starting after December 31, 2013, while the trust was not already subject to New York fiduciary income tax. Under the throwback rules, a beneficiary's distribution is deemed to include income earned in prior years, and thereby potentially increases the beneficiary's tax liability. The throwback tax will apply only to New York resident beneficiaries of trusts created by a New York resident grantor, where the trust is exempt from New York income taxation because it has no New York resident trustees, no New York source income, and no New York real estate or tangible personal property located in the state.[24] Note that the throwback rules do not apply to a Delaware Incomplete Non-Grantor (DING) Trust, which has separate and distinct status under New York law and is discussed beginning on page 21.

FREEDOM OF DISPOSITION

CONFIDENTIAL TRUSTS

A grantor may not want to disclose the existence of a trust to their beneficiaries because they fear that the knowledge of substantial wealth will reduce the beneficiary's incentive to lead a productive life, or for other reasons. Irrespective of the grantor's motivation to keep a trust confidential, this desire runs counter to a trustee's common law duty to disclose to a beneficiary their interest in a discretionary trust.[25] But, Delaware law permits a grantor to direct the trustee "for a period of time" not to fulfill their duty to inform the beneficiary of the beneficiary's interest in the trust.[26] A grantor might choose, for example, to prohibit the trustee from disclosing the existence of the trust until the grantor's youngest child reaches, say, 35 years of age. Or, the trust could remain confidential for a term of years, until a specific date, or until a specific event that is certain to occur. Regardless of the nature of the restriction a grantor imposes on the flow of information to beneficiaries, the grantor may direct nondisclosure to the beneficiaries as long as the expression of that intent is clear from the terms of the trust instrument, and the restriction on disclosure ends within a defined period of time.

There is not a specific definition of "period of time" in the statute. However, in 2015, § 3303 was modified to add the following safe harbors regarding what constitutes a "period of time." The statute reads: "the terms of a governing instrument may expand, restrict, eliminate, or otherwise vary the right of a beneficiary to be informed of the beneficiary's interest in a trust for a period of time, including but not limited to: (1) A period of time related to the age of a beneficiary; (2) A period of time related to the lifetime of each trustor and/or spouse of a trustor; (3) A period of time related to a term of years or specific date; and/or (4) A period of time related to a specific event that is certain to occur."[27] Note that if the trust is to be a confidential trust, most corporate trustees will prefer that the trust agreement directs the trustee not to provide notice for a period of time, rather than making it permissive that the trustee not provide notice for a period of time. Also, it is common for corporate trustees to have policies that limit the duration of a quiet trust, for example to the age of 35 for a beneficiary.

DESIGNATED REPRESENTATIVE STATUTE

Delaware statute, 12 *Del. C.* § 3339, allows the appointment of a "designated representative" who is authorized to receive trust information on behalf of, and represent and bind, any beneficiary where the governing instrument limits or restricts the beneficiary's right to receive information about the trust. The designated representative statute was enacted in 2015 to be used with confidential trusts created under § 3303. It was expanded significantly in 2021 to provide for representation of beneficiaries in various scenarios in addition to confidential trusts, as described below.

The statute offers various methods for appointing a designated representative. The first method is found under subsection (a) (1) of § 3339, which provides that "designated representative" means a person who is expressly appointed under the terms of a governing instrument. Under § 3339 (a) (2), a governing instrument may authorize, appoint or direct a person to represent or bind one or more beneficiaries in connection with a judicial proceeding or nonjudicial matter. "Judicial proceedings" and "nonjudicial matters" are both defined in 12 *Del. C.* § 3303(e), and the examples provided for nonjudicial matters include items such as nonjudicial release agreements.

Subsection (a) (3) allows a trust agreement to name a person who has the power to appoint a designated representative to fill either of the roles in subsections (a) (1) or (a) (2). This means that even if there is not a person named in the trust agreement to serve as the designated representative, the trust agreement can have express provisions to allow the appointment of a designated representative at any time.

To the extent that a designated representative is not appointed in accordance with subsections (a) (1) through (a) (3), § 3339(a) (4) authorizes the grantor to appoint a designated representative, subject to the limitations discussed below.

Subsection (a) (5) provides that to the extent a designated representative is not appointed in accordance with subsections (a) (1) through (a) (3), a beneficiary may appoint a designated representative to represent and bind the beneficiary. Thus, even if the trust is not a confidential trust, the beneficiary may decide that they would rather have information be provided to a designated representative or, for convenience, to represent the beneficiary in any nonjudicial matter.

The designated representative statute has been expanded to provide representation of beneficiaries where Delaware's virtual representation statute might not be available — even if the trust is not a confidential trust. Section 3339 (b) specifies that in addition to appointing a designated representative for a confidential trust, a designated representative may be appointed to represent "any minor, person who is incapacitated, or unborn person, or a person whose identity or location is unknown and not reasonably ascertainable" in any nonjudicial matter. This means that a designated representative can be appointed to provide representation of beneficiaries in nonjudicial matters, even if the trust is not a confidential trust. An example of where this could be useful is if a trustee or advisor wants to circulate a nonjudicial release agreement, and no party is available to serve as a virtual representative for minor and unborn beneficiaries under the virtual representation statute, 12 *Del. C.* § 3547.

As described beginning on page 19, Delaware's virtual representation statute has certain limitations as to who can serve in the role under various scenarios. However, it should be noted that the use of the designated representative statute as an alternative to virtual representation is limited to "nonjudicial matters." It does not apply to judicial proceedings. Furthermore, if the grantor is appointing a designated representative under subsection (a) (4) of § 3339 for representation in a judicial proceeding or nonjudicial matter, the grantor's ability to appoint a designated representative is limited by three factors. First, the appointed designated representative must serve in a fiduciary capacity. Second, the appointed designated representative cannot be a related or subordinate party to the grantor within the meaning of IRC § 672(c). And third, the grantor must provide written notice within 30 days of the appointment to the parent or guardian of the beneficiary being represented. The statute adds these additional requirements when the grantor is using the designated representative statute to represent and bind a beneficiary that would ordinarily be represented through virtual representation because without these limitations the grantor could unilaterally use the statute to avoid the restrictions of Delaware's virtual representation statute in nonjudicial matters.

Finally, subsection (b) provides that a beneficiary can appoint a designated representative to represent the beneficiary in any nonjudicial matter. Again, this means that a beneficiary can appoint someone to represent them, even if the trust is not a confidential trust. Note that this is limited to nonjudicial matters and does not apply to judicial proceedings.

The statute provides that a designated representative acting in a fiduciary capacity can reduce or extend any period of time that the trust is a confidential trust. The statute also provides that a designated representative can accept their

role in writing or through actual service or similar action. Thus, although the statute originally required the designated representative to accept thier role in writing, that is no longer required if it is clear that the designated representative has accepted thier role through thier actions. Last of all, the statute provides that by accepting the role, the designated representative submits to personal jurisdiction in Delaware regarding any matter related to the trust.

In addition, the nonjudicial settlement agreement statute, 12 *Del. C.* § 3338, and the statute permitting a modification of trust by consent while the grantor is living, 12 *Del. C.* § 3342, impose additional requirements where the grantor is naming a designated representative as part of the modification process. This is discussed in detail beginning on page 16.

AVOIDING POST-MORTEM CHALLENGES TO TRUSTS

Delaware law limits a person's ability to contest the validity of a trust if certain requirements are met. The Delaware statute provides that a trustee is permitted to give a person notice of the existence of a trust. This notice initiates a 120-day period in which the person may contest the validity of the trust. The written notice must specify the trustee's name and address, whether the person is a beneficiary of the trust, and the period of time the statute allows for bringing an action to contest the validity of the trust.[28] The statute effectively compels a dissenting person to mount a challenge to the validity of the trust while the grantor of the trust is still living and able to provide testimony to defeat allegations of incapacity or undue influence. The statute also forces the dissenting person to make the claim knowing that the grantor will be aware of the claim. This statute may be attractive to a client who wants to create a trust for the benefit of certain family members or charities, and who also wants the comfort of knowing that the family members will be precluded from challenging the trust after the grantor passes away. This statute was upheld by the Delaware Supreme Court in the *Ravet* case.[29]

The statute provides that either mailing or delivering the notice to a person's last known address constitutes receipt, absent evidence to the contrary. Notice is deemed to be given when sent to the person to whom the notice was given and, "absent evidence to the contrary, it shall be presumed that notice was received by the person seven days after it was sent to such person" in accordance with Delaware's notice statute.

Also, the statute creates the same type of pre-mortem validation for wills and certain exercises of powers of appointment.[30]

If a pre-mortem notice seems a bit extreme for a particular client, grantors still have the option to use a no-contest or "in terrorem" clause in a will or a trust.[31] An in terrorem clause is a provision that, if given effect, would reduce or eliminate the interest of any beneficiary of the will or trust who sues to contest the validity of the will or trust or to vary its terms. In terrorem clauses generally are enforceable under Delaware law, unless the court determines that a beneficiary who has brought an action has "prevailed substantially" in that action.

PURPOSE TRUSTS

At common law, a trust without definite beneficiaries, or at least readily identifiable beneficiaries, failed for lack of a proper object unless it qualified as a charitable trust.[32] The problem with such trusts was that without a certain class of beneficiaries, there was no one to enforce the trustee's duties under the trust agreement. In the case of a charitable trust, the power of enforcement resides in the attorney general, who has plenary authority to enforce a charitable trust within their jurisdiction.

A pair of Delaware statutes, 12 *Del. C.* §§ 3555 and 3556, eliminate the common law rule prohibiting non-charitable purpose trusts. Section 3555 permits a client to establish a pet trust — a trust for the benefit of "specific animals" living at the time of the settlor's death. Section 3556 authorizes a client to create a trust for a declared non-charitable purpose that is "not impossible of attainment."

Sections 3555(c) and 3556(c) authorize a person appointed under the trust agreement (i.e., a trust protector) or, if there is no such person, the Court of Chancery, to enforce the trust's purpose. The same provisions also give standing to a person who has an interest (other than a general public interest) in the welfare of the designated animal or in the declared purpose of the trust to petition the Court of Chancery to appoint a protector or remove an existing protector.

Apart from the "lives in being" limit on a trust created to care for one or more animals in § 3555(a), there is no stated limit on the duration of a purpose trust. Since Delaware has repealed its rule against perpetuities, a Delaware purpose trust can exist indefinitely. Upon the termination of a purpose trust, whether by its terms, the fulfillment of its purpose, or the depletion of its assets, any remaining assets are to be distributed under the terms of the trust agreement or, in the absence of any such direction, to the grantor's intestate heirs under Delaware law.

The nonjudicial settlement agreement (NJSA) statute (discussed in the next section) may not be used to modify charitable trusts and non-charitable purpose trusts unless (a) the purpose of the trust has become unconstitutional under Delaware law, (b) the trust would no longer serve a charitable purpose unless it were amended, or (c) the grantor is a party to the NJSA.

METHODS FOR MODIFYING A TRUST IN DELAWARE

DECANTING

Beginning with New York State in 1992, more than 30 states have adopted legislation to allow trustees with discretion to distribute trust principal to appoint some or all of such principal in favor of another trust. This process is known as "decanting" a trust, and it offers trustees the ability to modify terms of an irrevocable trust. The trend continues with the promulgation of the Uniform Trust Decanting Act by the Uniform Law Commission in 2015.[33] So far at least 14 states have enacted or introduced this uniform act, which evidences that the trend toward decanting is becoming more customary. Delaware's decanting statute was first enacted in 2003.[34] Under the statute, a trustee who has authority to make distributions of principal may instead exercise such authority by appointing all or part of the principal in favor of a trustee of a second trust. The second trust can be a new trust, or the second trust can be a modified version of the original trust. But, in order to decant a trust under the statute, the trustee must also satisfy the following conditions:

1. The trustee must exercise the decanting authority in favor of a receptacle trust having only beneficiaries who are "proper objects" of the exercise of the power (i.e., the second trust may narrow or limit the permissible beneficiaries of the first trust, but it may not add beneficiaries who were not already "proper objects" of the first trust);

2. If the first trust qualifies for treatment as a minor's trust under IRC § 2503(c), the beneficiary's remainder interest in the second trust must vest and become distributable no later than the date upon which such interest would have matured under the first trust;

3. The trustee's exercise of decanting authority cannot reduce any income interest of any income beneficiary of a trust for which a marital deduction is taken under IRC § 2056 or § 2523 or comparable state law;

4. The trustee's exercise of decanting authority cannot apply to assets subject to a beneficiary's presently exercisable power of withdrawal if that beneficiary is the only person to whom, or for the benefit of whom, the trustee has authority to make distributions; and

5. The trustee's exercise of such authority shall comply with any standard that limits the trustee's authority to make distributions from the first trust.

The process of decanting may be useful anytime an irrevocable trust agreement does not readily permit modifications under the authority of the trustee or a trust protector. Those modifications might include:

- Changing the law governing the administration of the trust to the law of a more favorable state;
- Dividing an existing trust to achieve tax benefits, such as maximizing GST-exempt assets;
- Transferring the situs of a non-grantor trust from a high income tax state to one without an income tax on fiduciary income;
- Converting a non-grantor trust into a grantor trust or a grantor trust to a non-grantor trust for fiduciary income tax purposes; and
- Modernizing a trust's governance procedure by appointing trust advisors and protectors.

The Delaware decanting statute provides significant latitude to decant a trust. Unlike the decanting statutes of some states, the Delaware statute permits a decanting even if the trust has an ascertainable standard for distributions. However, the second trust must have some or all of the same ascertainable standards. For example, if the first trust has an ascertainable standard of health, education, maintenance, or support, the second trust must be for the same standards, or for any one or more of those standards such as health and/or education. Also, some decanting statutes provide that a trustee can only decant income if the trustee has first accumulated the income and added it to principal. This is not required under the Delaware decanting statute. Finally, unlike some states, the Delaware decanting statute does not require notice to, or consent from, the beneficiaries before the decanting becomes effective. However, in practice most trustees will generally require that beneficiaries sign a release as part of the decanting process. Thus, a trustee with sufficient discretion to invade principal or pay income can enhance the benefits of an existing trust through judicious reliance on Delaware's decanting statute.

Prior to Trust Act 2018, the statute required the trustee to file a written statement of decanting in the trust files. The 2018 amendment removes this requirement to file the document in the trust files, although a written document is still required. In practice, this writing is sometimes referred to as an invasion document or a decanting document.

NONJUDICIAL SETTLEMENT AGREEMENT (NJSA) STATUTE

Delaware's NJSA statute provides a method for the "interested persons" of a trust to resolve matters regarding the administration of a trust without judicial involvement.[35] This statute is substantially similar to the NJSA statute found in the Uniform Trust Code.[36] However, unlike the Uniform Trust Code version, the Delaware statute provides that any interested person may bring a proceeding in the Court of Chancery to interpret, apply, enforce or determine the validity of a nonjudicial settlement agreement. The statute defines interested persons as those whose consent would be necessary to achieve a binding settlement if the settlement were approved by the Court of Chancery. The rules of the Court of Chancery provide that such persons include, but are not limited to the following: (i) trustees and other fiduciaries; (ii) trust beneficiaries (including remaindermen) with a present interest in the trust or whose interest would vest if the trust terminated currently. If the agreement changes any beneficial interests, all beneficiaries are necessary parties, not just beneficiaries, who would take currently if the trust were to terminate. So conceivably there could be remaindermen whose interest would not vest if the trust terminated currently, but rather would only vest upon a certain condition or specific event, and these parties would be necessary persons to the NJSA if beneficial interests are being changed; (iii) the grantor, if living; and (iv) all other persons having an interest in the trust pursuant to the express terms of the trust instrument, such as holders of powers and persons with other rights held in a non-fiduciary capacity. The statute provides that interested persons may enter into a binding nonjudicial agreement with respect to any matter involving a trust, provided it does not violate a material purpose of the trust.

The Delaware statute provides a non-exclusive list of six matters that may be resolved by a nonjudicial settlement agreement. These include: (i) interpreting or construing the terms of a trust; (ii) approving the report or accounting of a trustee; (iii) directing a trustee to refrain from exercising a power or granting a power to a trustee; (iv) resignation, appointment or determination of compensation of a trustee; (v) transferring the principal place of administration of a trust; and (vi) determining the liability of a trustee for an action relating to the trust.

As noted, this statute was based on the Uniform Trust Code, and comments to the Uniform Trust Code indicate that this list is a "non-exclusive list." This is of note since the list does not include an enumeration that the NJSA may be used to modify a trust. Historically, there were differing opinions among Delaware practitioners as to whether an NJSA could be used to modify a trust, or whether modifying a trust "violates a material purpose" of the trust.[37] When the grantor is alive and an interested person to the NJSA, the material purpose limitation does not apply.

Note that when a grantor is a party to an NJSA, then unless the transfer in trust is an incomplete gift for federal gift tax purposes, the grantor may not represent and bind any beneficiary (as a Designated Representative or through virtual representation) other than the grantor. In order to represent and bind other parties, the grantor, or a representative for the grantor, is required to confirm that the transfer to the trust was an incomplete gift for federal gift tax purposes. This provision is intended to address the concern that a grantor representing and binding beneficiaries could have adverse transfer tax consequences for the grantor, due to the grantor having a retained power over the trust.

As noted under the discussion of Purpose Trusts beginning on page 14, the Delaware NJSA statute provides that an NJSA may be used with charitable trusts and non-charitable purpose trusts. The limitation is that the NJSA statute may not be used to change the trust's purpose unless the trust has become unlawful under the Delaware Constitution or no longer serves any religious, charitable, scientific, literary, educational or non-charitable purpose. However, these restrictions do not apply if the grantor is a party to the agreement.

MODIFICATION OF TRUST BY CONSENT WHILE THE GRANTOR IS LIVING

Delaware statute 12 *Del. C.* § 3342 also provides for modification of a trust by consent while the grantor is living and requires that the grantor be a party to the modification. The statute provides that it can be used to modify existing provisions and add new provisions, so long as such provisions could have been included in the governing instrument if the trust were created upon the date of the modification.

The statute provides that a grantor's power to participate in a trust's modification may be exercised by an agent under a power of attorney, to the extent that that power expressly authorizes the agent to do so, or to the extent that the agent is expressly authorized by the terms of the trust's governing agreement. Alternatively, the guardian (or similar court appointed representative) of the grantor's property can

authorize the trust's modification with the approval of the supervising court. The statute also provides that a modification under the statute requires the participation of all grantors, if there is more than one grantor.

Similar to the NJSA statute, unless the transfer in trust is an incomplete gift for federal gift tax purposes, the grantor may not represent and bind any beneficiary (as a Designated Representative or through virtual representation) other than the grantor. In order to represent and bind other parties, the grantor, or a representative for the grantor, is required to confirm that the transfer to the trust was an incomplete gift for federal gift tax purposes. This provision is intended to address the concern that a grantor representing and binding beneficiaries when beneficial interests are being changed could have adverse transfer tax consequences due to the grantor having a retained power over the trust.

The Modification of Trust by Consent While the Grantor is Living statute may be used unless the trust's governing instrument expressly provides that the governing instrument may not be modified pursuant to this statute, a nonjudicial settlement agreement, or under a modification agreement.

DELAWARE'S MERGER STATUTE

Another method of potentially modifying a trust is the use of Delaware's merger statute.[38] Although this provision has long been one of several powers listed in the specific powers granted to trustees under the Delaware statute, this provision has gained additional utility in recent years, especially when decanting is not an option because the trustee lacks specific discretionary authority to distribute principal. The merger statute is often used in a manner similar to a decanting, where a new trust is created and the original trust is merged into the new trust. Delaware's merger statute gives a trustee the power to merge any two or more trusts, whether or not created by the same grantor, as long as the merger does not result in a material change in the beneficial interests of the trust beneficiaries. The statute does not require that the trusts that are being merged be created under the same instrument, or even by the same grantor. The statute does not define what constitutes a material change in the beneficial interests of trust beneficiaries. However, most practitioners in Delaware feel that as long as the resulting change is only administrative, such as adding an investment advisor, there is not a material change in the beneficial interests. Thus, in recent years, for administrative changes such as adding an investment advisor or updating investment language, the merger statute has become an alternative to decanting, or the use of an NJSA.

The merger statute also provides that the power to merge trusts is available when one of the trusts was created in order to participate in the trust merger, and that a trustee has the power to declare a trust for the purpose of merging existing trusts with that new trust. Furthermore, the power to declare trusts and merge trusts exists even if one or both of the trusts is not funded prior to the merger. This is important because it clarifies that the trust merger statute can be used to modify a trust, even if it is necessary to create a new trust that is not funded prior to the merger.

In addition to the requirement that the merger must not result in a material change in the beneficial interests of the trust beneficiaries, there are other important considerations for a merger. If a trust is being moved from another state and is being modified as part of that move, advisors should examine the application (if any) of the other state's merger statute. Additionally, any merger provision contained within the trust instrument should be considered.

AUTHORITY TO ALLOCATE TRUSTEE DUTIES AMONG MULTIPLE TRUSTEES

Delaware statute 12 *Del. C.* § 3343 provides another tool that can be used to modify irrevocable trusts where the desired modification solely addresses powers of the trustee. The statute provides that any fiduciary who has the power to appoint a successor trustee has the power to appoint multiple successor trustees and additional trustees. Notably, this appointment power includes the power to allocate various trustee powers "exclusively to one or some of the trustees serving from time to time." Pursuant to § 3343(c) and in accordance with § 3313A, a trustee to whom powers are exclusively allocated under this section is a fiduciary only with respect to the powers that are allocated. The statute makes it clear that the other trustee(s) who were not allocated such power have no liability for, and no duty to monitor, the actions of the trustee to whom those powers, duties and responsibilities were allocated. The statute clearly states that if the powers are bifurcated with any trustee not having certain powers, the trustee that does not have those powers is an "excluded trustee" and will not be subject to liability with regard to those powers. Therefore, advisors and fiduciaries might now consider using section § 3343 to specifically allocate powers and duties among different trustees, limit liability, and avoid the need for a full decanting, but still obtain all the benefits of a decanting.

THE CONSENT PETITION PROCESS IN THE DELAWARE COURT OF CHANCERY

Historically, the Delaware Court of Chancery allowed "consent petitions" for the purpose of reforming irrevocable trusts. If all of the interested parties to the trust agreed, the trust could be reformed for a proper purpose.

On June 2, 2010, the Court entered a standing order formalizing the long-standing procedure for filing consent petitions in the Court of Chancery. On October 31, 2012, the Court of Chancery entered a standing order amending the rules governing the consent procedure process. This standing order increased the requirements for a successful consent petition and indicated the Chancery Court's desire to look more closely at the overall procedure.

In December 2012, the Court of Chancery continued its increased scrutiny of the consent petition process in its opinions in the *Peierls* matter.[39] In these decisions, the court questioned whether a family of related trusts could be transferred to Delaware and modified through the consent petition process. The rulings were appealed to the Delaware Supreme Court, which ruled on the Chancery Court's holdings on October 4, 2013.[40] The Delaware Supreme Court's opinions in *Peierls* provide a roadmap for the successful use of the consent petition procedure and set out the following guidelines:

1. Unless a choice of law provision in the trust specifically and expressly provides that another jurisdiction's laws shall always govern administration, Delaware law will govern the administration of any trust moved to Delaware that allows the appointment of a successor trustee without geographic limitations, once the Delaware trustee is appointed and the trust is administered in Delaware;

2. While it is possible for the Delaware Court to have jurisdiction along with another state, if that other state has exercised primary supervision, such as court accountings for the trust, Delaware will not exercise jurisdiction over the trust until the other court has expressly relinquished primary supervision;

3. While historically Delaware trustees accepted their appointment contingent upon the modification of the trust, Delaware trustees must now accept their appointment before the Delaware Court will accept jurisdiction. Thus, the practice of accepting an appointment contingent on the modification of a trust is no longer in existence;

4. Whereas the consent petition process referred to the "reformation" of a trust, the actual effect is now a modification of a trust, since a reformation is used only where there is a mistake by all parties during the creation of the trust, and not merely where the parties are requesting a subsequent change to the trust; and

5. The Court of Chancery will not issue advisory opinions, in that it will no longer enter an order regarding any matter that could be accomplished without court approval, such as the appointment of a successor trustee where such a provision is contained in the trust.

On balance, although the Court of Chancery *Peierls* opinions initially cast doubt on the viability of the consent petition process, the Delaware Supreme Court decision in *Peierls* validated the process and provided a roadmap for utilizing the process successfully.

Delaware statute 12 *Del. C.* § 3332 codifies and expands on the *Peierls* decision. The statute provides that when a trust is transferred to Delaware from another jurisdiction, Delaware law will govern the administration of the trust while the trust is administered in Delaware, with certain exceptions. The exceptions are where the trust instrument expressly provides either: (i) that the laws of another jurisdiction govern the administration of the trust (more than just a general choice of law provision in the trust); or (ii) that the laws governing the administration of the trust will not change due to a change in the place of administration of the trust.

In June 2015, the Court of Chancery issued an order in the *Flint* case, which established an additional test for the judicial modification of trusts.[41] The new test requires the court to consider the grantor's intent as part of the modification process. In the *Flint* matter, the petitioner was seeking an order to modify the trust to clarify the governing law of the trust and to add an investment advisor. The court declined to determine the governing law because it felt the language of the proposed modification was too vague to be implemented. More importantly, the court did not grant the order to add an investment advisor, stating that modifying a trust requires the court to consider the grantor's intent, and the grantor was no longer alive. This appears to add a new "grantor intent" test to the consent petition process.

VIRTUAL REPRESENTATION OF MINOR, UNBORN AND OTHER BENEFICIARIES WHO CANNOT REPRESENT THEIR OWN INTERESTS

Background of Delaware's Virtual Representation Statute

Enacted in 2000, Delaware's virtual representation statute 12 *Del. C.* § 3547 provides that a minor, an incapacitated person, unborn person, or a person whose identity is unknown or not reasonably ascertainable, may be represented and bound in judicial and nonjudicial matters by another person who has a substantially identical interest with respect to the matter at hand. However, this is limited in that the person can represent and bind another only to the extent there is no material conflict of interest with respect to the particular question or dispute between the representative and the person being represented. Another limitation is that if a person is acquiring or increasing a fiduciary or non-fiduciary role as part of the particular question or dispute for which representation is being sought, that person cannot represent and bind others as this is deemed to be a material conflict. For example, if as part of a proceeding a person is becoming an investment advisor who will direct the trustee, that person cannot represent and bind others for that proceeding.

The parent or parents of a minor or incapacitated beneficiary may represent and bind the child, as long as neither parent has a material conflict of interest with the child with respect to the question or dispute that is the subject of the representation. The statute also provides the ability of the parent or parents to represent and bind unborn or unascertainable persons with an interest that is substantially identical to their child's interest.

Parents can also represent and bind another minor, incapacitated or unborn person who has an interest that is substantially identical to the parents' own minor, incapacitated or unborn child, provided there is no material conflict of interest between their child and the other minor, incapacitated or unborn person. An example of where this could be useful is where a parent is becoming an investment advisor as part of the proceeding, and as noted above, the parent would not be able to serve as the virtual representative for their own children due to the deemed conflict of interest. However, if the class of beneficiaries included "descendants" and included nieces or nephews of that parent, assuming the niece or nephew has a substantially identical interest as the child of the parent who cannot serve in this role, the parent of the niece or nephew (the sibling of the conflicted parent) could serve as the virtual representative for all of the beneficiaries with the substantially identical interest, including the children of the parent who cannot serve in this role due to the deemed conflict.

A presumptive remainder beneficiary can represent and bind contingent successor remainder beneficiaries as long as there is no material conflict.

Subsection (b) provides that contingent remainder beneficiaries may represent and bind more remote contingent successor remainder beneficiaries. As a result, in a situation where a presumptive remainder beneficiary is not able to represent and bind contingent successor remainder beneficiaries, for example if the presumptive remainder beneficiary is assuming a fiduciary role, a contingent successor remainder beneficiary can fill the role of virtual representative for more remote beneficiaries.

Subsection (c) provides that "the holder of a general testamentary or inter vivos power of appointment — or a nongeneral testamentary or inter vivos power of appointment that is expressly exercisable in favor of any person or persons, excepting such holder, their estate, their creditors or the creditors of their estate — may represent and bind persons whose interests, as takers in default, are subject to the power, but only to the extent that there is no material conflict of interest between the holder and the persons represented with respect to the particular question or dispute." This means that a holder of a power of appointment of any type, other than a power limited to a specific class, can serve as the representative. As a result, presumptive remainder beneficiaries, contingent successor remainder beneficiaries and more remote beneficiaries can all be represented by a holder of a power of appointment as long as there is no material conflict of interest. As a result, it is possible to represent and bind these beneficiaries without having a remainder beneficiary serving as a representative.

Subsection (g) provides that "when a trust (the "beneficiary trust") is a beneficiary of another trust, the beneficiary trust shall be represented by its trustee or, if the beneficiary trust is not in existence, the beneficiary trust shall be represented by those persons who would be beneficiaries of the beneficiary trust if the beneficiary trust were then in existence."

ACTIONS AGAINST A TRUSTEE

The Delaware statute[42] places a limit on the time that a party may initiate a claim against a trustee. Any person may initiate a proceeding up to the earlier of one year after the person was sent a report that adequately disclosed the facts constituting a claim (this is generally satisfied by trust statements showing

the trust assets and transactions), or the date the proceeding was otherwise precluded by adjudication, release, consent, or pursuant to the terms of the governing document. If the trust is in the process of terminating, this period is 120 days. The period to bring a cause of action begins when the report is received by the person, and the statute codifies a presumption of receipt seven days after the notice is sent, absent evidence to the contrary.

ELECTRONIC EXECUTION OF DOCUMENTS

The Electronic Execution of Documents statute, 12 *Del. C.* § 3550, was enacted in 2021 largely due to the impact of COVID-19. Under this statute, inter vivos trust agreements as well as most other documents related to an inter vivos trust agreement can be executed electronically in accordance with Delaware's Uniform Electronic Transactions Act (UETA).[43]

The statute works by providing that if a document is otherwise validly executed, the document may be executed in accordance with Delaware's UETA. The UETA has been a part of the Delaware Code since 2000. However, it has not been completely clear whether the UETA pertains to personal trusts. This is largely due to the following facts: that the UETA is contained in Title 6 of the Delaware Code, which pertains to Commerce and Trade, whereas fiduciary matters such as personal trusts, wills, estates and guardianships are addressed in Title 12 of the Delaware Code; and that the UETA refers to "transactions between two or more persons relating to the conduct of business, commercial or governmental affairs." Finally, the UETA excludes the execution of wills, codicils and testamentary trusts. To clarify its application, § 3550 references the UETA and provides that all of the documents covered in § 3550 are deemed to be a "transaction" as covered in the UETA.

The documents covered under § 3550 include just about any type of document that will be involved in any of the following: the execution of an inter vivos trust; the modification of a trust through modification agreement, merger or decanting; any release agreements; any resignation, removal, appointment, or acceptance of appointment of a trustee, advisor, designated representative, or protector; and any other documents covered under Chapters 33 and 35 of Title 12 of the Delaware Code that are not specifically excluded under the UETA. Note that § 3550 does not cover the execution of a will or a codicil.

ASSET PROTECTION WHERE GRANTOR MAY BECOME A BENEFICIARY AT A LATER TIME

The Delaware statute[44] provides that if a grantor later becomes a beneficiary of a trust that they created, perhaps through the creation of a new trust under the exercise of a power of appointment in the trust the grantor previously established, that grantor of the original trust, now in the shoes of a beneficiary of the new trust created by the exercise of the power of appointment, is not a grantor of the new trust created by the exercise of the power of appointment. This is important in that it is intended to protect the assets in the trust created by the exercise of the power of appointment from the claims of the creditors of the beneficiary who was the grantor of the original trust, and therefore such assets should not be includible in the estate of the beneficiary who was the grantor of the original trust.

TRUSTEE'S EXERCISE OF DISCRETION; REVIEW BY COURT; DISCRETIONARY INTERESTS

The Delaware statute provides that "a beneficiary eligible to receive distributions from a trust in the discretion of a trustee or other fiduciary has a discretionary interest in the trust. A discretionary interest in a trust is a mere expectancy, not a property right."[45] The statute goes on to provide that this is true even if the discretionary interest is subject to an ascertainable standard. This addresses the criticism that was sometimes heard about Delaware law from practitioners outside of the state, saying that it was not clear whether under Delaware law a discretionary interest is a property right, and therefore it is not clear that it is not subject to the claims of the creditors of the discretionary beneficiaries of the trust. This modification addresses that concern directly.

DELAWARE SELF SETTLED ASSET PROTECTION TRUSTS (SSAPT)

We turn now to a topic that has received significant attention since 1997, when the first SSAPT statute was enacted.[46] Oftentimes this topic is covered under the term Domestic Asset Protection Trusts (DAPT) or simply asset protection trusts. Since trusts created for third-party beneficiaries generally have spendthrift provisions, those can be viewed as asset protection trusts as well. However, beginning in 1997, new laws began allowing a person to be both the grantor and a beneficiary of a trust, thus self-settled, and if done properly, under the given statute the assets in the trust should be shielded from the claims of the grantor's creditors as well as the claims of creditors of the third-party beneficiaries of the trust.

This legislative change represents a shift in centuries-old law. The Restatement (Second) of Trusts provides a good example of the common law view. It reads that "where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount

which the trustee under the terms of the trust could pay to him or apply for his benefit."[47] Thus, the SSAPT legislation overrides the Restatement (Second) of Trusts. Currently there are at least 20 states with some type of legislation enabling the creation of a SSAPT.[48] In 1997, Delaware became the second state to enact a SSAPT statute with the Qualified Dispositions in Trust Act (QDTA).[49]

Under the Delaware statute, a settlor can be a beneficiary as well as settlor, and their creditors should not be able to reach the assets in the trust as long as certain rules are followed. These rules include the following requirements: (i) the transfer is to an irrevocable trust; (ii) the trust must have a Delaware resident trustee; (iii) the trust must incorporate Delaware law; and (iv) the trust must have a spendthrift clause. The settlor is allowed to retain certain rights, which include: (i) the ability to be a permissible beneficiary as to principal and income; (ii) the right to veto distributions of income or principal to other beneficiaries; and (iii) the ability to have a limited inter vivos and/or testamentary power of appointment, the power to appoint and remove trustees and advisors, and the ability to serve as an investment advisor. Note that the settlor cannot serve as a trustee. In short, the settlor can be a permissible beneficiary and their creditors should not be able to bring a cause of action against the trust to settle an order to satisfy a debt owed by the settlor to the creditor, provided none of the asset transfers are found to be fraudulent. The time period that a creditor can bring a cause of action is limited. If the person is a creditor when the assets are transferred to the trust, the creditor must bring the cause of action within the later of four years after the transfer to the trust is made, or two years after the transfer could have been reasonably discovered by the creditor. If the person becomes a creditor after the transfer of assets to the trust, the creditor must bring the cause of action within four years. To be successful during this period, the creditor must prove that the settlor's transfer of assets to the trust was a fraudulent transfer.

Most SSAPT statutes have various types of "exception creditors" where there is no statute of limitation for the time that the claim can be brought against the trust. The Delaware statute has exception creditors that include marital relations claims such as an order for alimony, child support or property division, as well as claims based on torts such as property damage, bodily injury or death.

Asset protection trusts serve a variety of well-intentioned clients who simply seek to safeguard a portion of their net worth from unforeseen and uninsured claims against their wealth, but they should be a part of the client's overall estate planning. They should be funded with a portion of a grantor's net worth, but the grantor should retain sufficient assets outside of the trust to satisfy his or her ongoing lifestyle expenses. Although there has been some case law upholding the asset protection nature of these trusts, in large part the case law across the country is mixed.

DELAWARE INCOMPLETE NON-GRANTOR (DING) TRUSTS

A DING is a type of self-settled asset protection trust with a specific set of provisions and particular objectives. A client whose portfolio includes an asset with substantial unrealized gains or recurring ordinary income may be interested in planning devices that could minimize the state income tax consequences from the realization of such income, while allowing them to retain the economic benefit of the asset. In recent years, clients have relied upon the disconnect between the federal income tax regime and the federal gift tax regime to create an irrevocable trust that eliminates the state income tax liability attributable to the asset while avoiding or deferring a gift for federal gift tax purposes. These have become known as "Incomplete Non-Grantor Trusts" or "ING" trusts. In Delaware, as mentioned above, these trusts are known as Delaware Incomplete Non-Grantor Trusts or DING trusts.

As of the date of this piece, Incomplete Non-Grantor Trusts have been placed on the no ruling list by the Internal Revenue Service. Thus at this time, the federal tax consequences of creating and funding a DING are uncertain.

Prior to incomplete non-grantor trusts being placed on the no ruling list, private letter rulings from the IRS confirmed that a client may rely on the law of any state that permits the creation of self-settled asset protection trusts to create a trust that "traps" income within the trust and does not pass such income through to the trust's grantor for income tax purposes. Such non-grantor trusts may be funded with contributions that are not taxable gifts for federal gift tax purposes. Crafting a DING trust agreement requires a bit of maneuvering between the income tax and gift tax provisions of the IRC. The grantor must relinquish sufficient interest in, and control over, the trust so as to avoid grantor trust status for the trust, without surrendering so much interest and control that they will have made a completed gift upon funding the trust. In order to avoid grantor trust status, the trust agreement establishes a distribution committee comprised of other beneficiaries of the trust (i.e., "adverse parties" within the meaning of IRC § 672(a)), whose consent is required in order for the grantor

or the grantor's spouse to receive discretionary distributions from the trust or for the trustee to accumulate income in the trust potentially subject to the grantor's testamentary limited power of appointment. The other beneficiaries are typically the grantor's parents, siblings or adult children. If the grantor retains a limited power of appointment over all of the trust property and the power of appointment is effective at the grantor's death, the transfer of assets into the trust will be incomplete for gift tax purposes until the earlier of the grantor's death or a distribution of trust assets to one of the other beneficiaries (but only as to such distributed assets).

State taxing authorities may attack obviously abusive transactions using ING trusts that are designed primarily to avoid the imposition of state income tax on a particular transaction, such as the disposition of a block of highly appreciated stock. Consequently, advisors should counsel their clients to avoid funding a DING trust with assets that are certain or even likely to be sold shortly after the creation of the trust. A DING trust can become even more vulnerable to attack if a sale of its principal asset is followed by a distribution back to the grantor of all, or a large portion, of the sale proceeds.

The grantor's home state taxing authority could view such a transaction as a "sham" and might attack it based on form over substance, assignment of income, or some similar theory that would effectively disregard the non-grantor trust and treat the grantor as the seller in fact.

Ideally, DING trusts should be created only with the intent to continue the trust at least for the lifetime of the grantor. Grantors should avoid transferring a portion of their assets to a trust that is so large that the grantor will need routine distributions from the trust to pay for living expenses. Optimally, for creditor protection as well as sound tax planning, advisors should generally recommend that their clients fund such trusts only with those assets that the client likely will never need to expend, absent extraordinary events. Given the uncertainty under the current environment concerning the tax treatment of ING trusts, Northern Trust serves as trustee of new ING trusts on an exception basis.

CONCLUSION

Delaware continues to be a leading jurisdiction for personal trusts, largely due to the flexible laws, its deep infrastructure for the trust and estates industry, a sophisticated legal bar and judicial system, and a progressive and amenable legislative process. To learn more, please contact your Northern Trust representative or one of the individuals provided below.

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ENDNOTES

1 See, e.g., Lockwood v. OFB Corp., 305 A.2d 636 (Del. Ch. 1973) (a trustee is obliged to see that a trust is productive and that its corpus is preserved).

2 12 *Del. C.* § 3313(a).

3 2009 WL 2913893 (Del. Ch. 2009).

4 12 *Del. C.* § 3302(a)

5 12 *Del. C.* § 3302(a)(4)

6 Uniform Directed Trust Act 2017, https://www.uniformlaws.org.

7 Willful misconduct means "intentional wrongdoing, not mere negligence, gross negligence or recklessness." 12 *Del. C.* § 3301(g). The 2011 amendment to § 3301(g) further clarified the meaning of willful misconduct by defining "wrongdoing" as "malicious conduct or conduct designed to defraud or seek an unconscionable advantage." Notably, in July 2017, the Uniform Laws Commission finalized the Uniform Directed Trust Act, which is a model law that states can adopt. The willful misconduct standard in this Uniform Act is based on the Delaware statute, affirming Delaware's leadership in the development of directed trusts.

8 C.A. No. 20033 N.C. (Del. Ch. 2004).

9 *Id.* at 2.

10 12 *Del. C.* § 3313A(a)(1).

11 IRC § 2601.

12 IRC § 2631(a); An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, 131 Stat. 2126 (2017).

13 25 *Del. C.* § 503(a). Three other states — South Dakota, Idaho and Wisconsin — had repealed the Rule prior to 1986, for reasons obviously unrelated to the advent of the GST tax.

14 25 *Del. C.* § 503(e).

15 *See*, R. Sitkoff and M. Schanzenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale Law Journal 356 (2005).

16 30 *Del. C.* § 1635(a).

17 Ibid.

18 Cal. Rev. and Tax. Code § 17742(b).

19 See, e.g., Cal. Rev. and Tax. Code §§ 17734, 17737; N.Y. Tax Law § 633(a).

20 504 U.S. 298 (1992) (due process clause requires minimum contacts between a state and a taxpayer to justify state's authority to impose tax).

21 *See*, e.g., *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999); *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997).

22 *McNeil v. Commonwealth of Pa.*, 67 A.3d 185 (Pa. Commw. Ct. 2013) (holding that despite the grantor's Pennsylvania residency at the time of the trust's creation, because the trust had no Pennsylvania beneficiaries or other connections, the imposition of a Pennsylvania fiduciary income tax violated both the Pennsylvania and U.S. Constitutions); *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013) (finding that the income taxation of the trust in question violated the Due Process Clause of the U.S. Constitution because there was not a sufficient minimum connection between the trust and the state of Illinois); *Fielding v. Commissioner of Revenue*, 916 N.W. 2d 323 (2018) (holding that four irrevocable inter vivos trusts lacked sufficient relevant contacts with Minnesota during the relevant tax year to be permissibly taxed, consistent with due process, on all sources of income as resident trusts.

23 *North Carolina Department of Revenue v. Kimberly Rice Kaestner* 1992 Family Trust, 588 U.S. __ (June 21, 2019).

24 N.Y. Tax Law § 612(b)(40).

25 See, *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001), aff'd in part sub nom. *McNeil v. McNeil*, 798 A.2d 503 (Del. 2002).

26 12 *Del. C.* § 3303.

27 12 *Del. C.* § 3303(c).

28 12 *Del. C.* § 3546(a).

29 In a case of first impression, the Delaware Supreme Court upheld § 3546(a). See In re Restatement of Declaration of Trust Creating the Survivor's Trust Created Under the Ravet Family Trust Dated Feb. 9, 2012, C.A. No. 7743-VCG (Del. Ch. 2014), aff'd sub nom. *Ravet v. Northern Trust Co. of Delaware*, No. 369, 2014 (Del. 2015) (individual who had received notice under the statute and brought a cause of action after the 120-day period was denied relief because he failed to bring his claim within the statutory period).

30 12 *Del. C.* §§ 1311 and 1312.

31 12 *Del. C.* § 3329.

32 See, *Morice v. Bishop of Durham*, 9 Ves. 399 (1804).

33 Uniform Decanting Trust Act 2015, https://www.uniformlaws.org.

34 12 *Del. C.* § 3528.

35 12 *Del. C.* § 3338.

36 Uniform Trust Code § 111, Nonjudicial Settlement Agreements.

37 *See, e.g.*, Vincent C. Thomas, A Trustee's Modification Toolbox: Does it Really Include Nonjudicial Settlement Agreements?, Delaware Banker, Vol. 10, No. 2, Spring 2014, for the view that the Delaware NJSA should not be used to modify a trust; But *see also*, Michael M. Gordon and Daniel F. Hayward, Another View: Utilizing Nonjudicial Settlement Agreements to Modify Trusts, Delaware Banker, Vol. 10, No. 3, Summer 2014, for the view that the Delaware NJSA is one of several tools available to modify a trust in Delaware.

38 12 *Del. C.* § 3325(29).

39 *In re the Ethel F. Peierls Charitable Lead Unitrust*, C.M. No. 16811-N-VCL (December 10, 2012); *In re the Peierls Family Inter Vivos Trusts, Consolidated* C.M. No. 16812-N-VCL (December 10, 2012); *In re the Peierls Family Testamentary Trusts*, Consolidated C.M. No. 16810-N-VCL (December 10, 2012).

40 *IMO Peierls Family Inter Vivos Trusts*, No. 16812 (Del. 2013); *IMO Ethel F. Peierls Charitable Lead Trust*, No. 16811 (Del. 2013); *IMO Peierls Family Testamentary Trusts*, No. 16810 (Del. 2013).

41 *In re Trust Under Will of Wallace B. Flint for the Benefit of Katherine F. Shadek*, C.A. No. 10593–VCL (Del. Ch. 2015).

42 12 *Del. C.* § 3585.

43 Uniform Electronic Transactions Act, 6 *Del. C.* Chapter 12A.

44 12 *Del. C.* § 3536(c).

45 12 *Del. C.* § 3315.

46 Alaska Stat. §§ 13.36.310, 34.40.110.

47 Restatement (Second) of Trusts § 156 (1969).

48 Thirteenth ACTEC Comparison of the Domestic Asset Protection Trust Statutes, https://www.ACTEC.org.

49 12 *Del. C.* § 3528.

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