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LEGAL MEMORANDUM

TO: **CPAs, Clients & Associates**

FROM: **David L. Silverman, Esq.**
Shirlee Aminoff, Esq.

DATE: **April 2, 2010**

RE: **Delaware Asset Protection Trusts**

EPTL § 7-1.3 provides in stark language that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator." This prohibition against self settled spendthrift trusts has led some New York residents to create asset protection trusts in exotic places such as the Cayman or Cook Islands, or in less exotic ones, such as Bermuda or Switzerland. Although the IRS recognizes the bona fides of foreign asset protection trusts, it also seeks to tax such trusts, and has at its disposal an arsenal of imposing Code provisions designed to accomplish that objective. Contrary to some assertions, offshore trusts do not accomplish legitimate tax savings.

Within the past few years, a few states have enacted trust laws that permit what EPTL § 7-1.3 does not: Delaware, a perennially friendly jurisdiction for business entities, in 1997 enacted the "Qualified Dispositions in Trust Act." Under the Act, a person may create an irrevocable Delaware

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Any advice herein is not intended or written by our firm to be used, and cannot be used by any taxpayer, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code. Advice from our firm relating to Federal tax matters may not be used in promoting, marketing or recommending any entity, investment plan or arrangement to any taxpayer.

Trust whose assets are beyond the reach of the settlor's creditors. However, the settlor may retain the right to receive income distributions and principal distributions subject to an ascertainable standard. Delaware is an attractive trust jurisdiction for many reasons: first, it has eliminated the Rule Against Perpetuities; second, it imposes no tax on income or capital gains generated by an irrevocable trust; third, it has adopted the "prudent investor" rule, which accords the trustee wide latitude in making trust investments; fourth, it permits the use of "investment advisors" who may inform the trustee in investment decisions; and fifth, Delaware trusts preserve confidentiality, since Delaware courts do not supervise trust administration.

To implement a Delaware trust, a settlor must make a "qualified disposition" in trust, which is a disposition by the settlor to a "qualified trustee" by means of a trust instrument. A qualified trustee must be an individual other than the settlor who resides in Delaware, or an entity authorized by Delaware law to act as trustee. The trust instrument may name individual co-trustees who need not reside in Delaware. The trust may designate investment advisors and "protectors" from whom the trustee must seek approval before making distributions or investments. Thus, the settlor, even though not a trustee, may retain the power to make investment decisions and participate in distribution decisions, even to himself. [Delaware trusts may also be structured so that the assets transferred are outside the settlor's gross estate for estate tax purposes. If, instead of gifting the assets to the trust, a sale is made to a Delaware irrevocable "defective" grantor trust, the assets may be removed from the settlor's estate a reduced estate tax cost.]

Delaware law governing Delaware trusts is entitled to full faith and credit in other states, a crucial advantage not shared by trusts created in offshore jurisdictions. The Delaware Act bars actions to enforce judgments entered elsewhere, and requires that any actions involving a Delaware trust be brought in Delaware. A New York court might therefore find it difficult to declare a transfer fraudulent if, under Delaware law, it was not. In any event, a Delaware court would not likely recognize a judgment obtained in a New York court with respect to Delaware trust assets. Foreign trust jurisdictions possess what appears to be the attractive feature of short statutes of limitations for

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recognizing “foreign” (i.e., United States) judgments. A person ill-advised could attempt to create a foreign situs trust shortly before a claim was reduced to judgment, even though under state law such transfer would clearly be fraudulent. Although courts in offshore jurisdictions might reject creditors’ claims, U.S. courts would likely be unwilling to apply the short period of limitations provided by foreign law, and might find such a transfer to be fraudulent.

Prudently, the Delaware Act does not contain as short a limitations period as do most offshore jurisdictions. A creditor’s claim against a Delaware trust is extinguished unless (i) the creditor’s claim arose before the qualified disposition was made and the creditor brings suit within four years after the qualified disposition or (ii) the creditor’s claim arose after the qualified disposition and the creditor brings suit within four years after the qualified disposition. (Claims for alimony and child support are not subject to the Delaware Act.) Although the Delaware statute affords more protection for creditors than do offshore trusts, the four-year period for commencing legal action reduces the risk that a creditor whose claim is time-barred could successfully assert that (i) a transfer was fraudulent notwithstanding the Act or (ii) the Act’s statute of limitations is itself unconstitutional.

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