

## Trust Act 2014 Legislative Update

On February 25, 2014, Delaware Governor Jack Markell signed Senate Bills 155 and 156 into law, effective immediately. On July 22, 2014, Governor Markell signed House Bill 142 into law, effective as of August 1, 2014. These laws (collectively “Trust Act 2014”) provide many advancements in Delaware trust law that will provide settlors, beneficiaries and fiduciaries of trusts with more tools and greater flexibility to accomplish their various objectives. The Morris Nichols’ Trusts, Estates and Tax Group is pleased to share this Delaware legislative update with you. If you would like to discuss any of the issues raised in this Alert in greater detail, please feel free to contact any member of the Morris Nichols’ Trusts, Estates and Tax Group.

## Revisions to Asset Protection Trust Statutes (12 Del. C. §§ 3570 *et seq.*)

Trust Act 2014 made a number of revisions to Delaware’s “Qualified Dispositions in Trust Act” that prescribes the requirements for a valid self-settled asset protection trust in Delaware (an “APT”).

### Lifetime Limited Power of Appointment Permissible

Section 3570(11) of Title 12 of the Delaware Code defines the term “trust instrument” and lists several rights and powers that the settlor of an APT may retain while still complying with the requirements of the Qualified Dispositions in Trust Act. As revised, Subsection 3570(11)b.2 now permits the settlor of an APT to retain a lifetime limited power of appointment over the APT, rather than just a testamentary limited power of appointment as paragraph (11)b.2 previously provided.

Delaware’s Qualified Dispositions in Trust Act has been used to form so-called “DING Trusts” (Delaware Incomplete Gift Non-Grantor Trusts) since at least 2001, when the first Private Letter Ruling (“PLR”) was issued by the IRS regarding a DING Trust. Between 2007 and 2013, DING Trusts have had a rocky history, due to uncertainty as to the IRS’ view regarding an unwillingness to grant PLRs for DING Trusts. In PLR 201310002, the IRS ruled that a domestic self-settled APT was wholly incomplete for federal gift tax purposes because a majority of the Distribution Committee members responsible for making distributions from the APT could make discretionary distributions of net income and principal to the settlor and his issue with the written consent of the settlor (the “Settlor’s Consent Power”). The settlor in PLR 201310002 also retained a lifetime limited power of appointment, but the IRS clearly stated that the Settlor’s Consent Power alone was enough to make the gift to the APT wholly incomplete. Accordingly, DING Trusts made a strong return after PLR 201310002 even though the precise provisions of the APT involved could not exactly be replicated in Delaware as it could in other states with self-settled asset protection trust legislation, like Nevada.

The revisions to Subsection 3570(11)b.2 now expressly permit the settlor of a Delaware APT to retain an inter vivos limited power of appointment and, accordingly, DING Trusts of the sort described in PLR 201310002 can be exactly replicated in Delaware. If a trust described in PLR 201310002 is created in a state such as Delaware that does not tax income and capital gains accumulated in the trust, the trust may be a powerful income tax planning vehicle for settlors living in states that do not tax the trust’s accumulated income and capital gains merely because the settlor resides in that state or because of some other connection between the settlor and the settlor’s home state.

## Other Revisions Related to the Asset Protection Statutes

Paragraph (8) of Section 3570 of Title 12 was reorganized as part of Trust Act 2014 to make clear that a “qualified trustee” (that is a Delaware trustee of a Delaware APT) must meet the requirements in paragraph (8)a and (8)b of Section 3570, and that the language in paragraphs 8(c) through (f) does not impose additional requirements for a trustee to qualify as a “qualified trustee”. This revision clarifies existing law.

Paragraph 8(d) of Section 3570 was revised to clarify that the settlor of an APT cannot serve as trustee, notwithstanding the ability of the settlor to serve as an “investment adviser” for the APT as described in Section 3313. This revision clarifies existing Delaware.

Paragraph (11)b.6 of Section 3570 was revised to clarify that the settlor of a Delaware APT’s right to use principal of the APT includes the right to use real property or tangible personal property held by the APT. This revision clarifies existing Delaware.

Paragraph (11)b.7 of Section 3570 was revised to provide that the settlor of a Delaware APT may retain the right to appoint an additional trustee or adviser. This revision clarifies that the settlor’s right to remove and appoint trustees and advisers subsumes the right to appoint additional trustees and advisers.

Paragraph (11)b.8 of Section 3570 was revised to correct a cross-reference and align the paragraph with applicable provisions of the Treasury Regulations regarding a so-called “qualified personal residence trust” (a “QPRT”). This revision clarifies that, under existing Delaware law, an APT may be structured as a QPRT.

Paragraph (11)b.9 of Section 3570 was revised to provide that a settlor who retains a lifetime limited power of appointment may direct the trustee to pay the income tax of the APT. Previously, paragraph (11)b.9 provided that a settlor may retain the right to receive income or principal to pay income taxes due on the income of the APT only as a result of (i) a qualified trustee acting at its discretion or pursuant to a mandatory direction in the trust instrument, or (ii) upon the direction of an “adviser” (as described paragraph (8)c) acting in such adviser’s discretion with respect to the APT. The revision to paragraph (11)b.9 is notable because it grants an additional right to the settlor to direct the trustee of an APT to pay the APT’s income tax liability. This retained power may provide greater flexibility the settlor of an APT structured as an incomplete gift and grantor trust for federal tax purposes to choose whether the settlor or the APT will pay the federal income tax on the APT.

Paragraph (f) of Section 3574 was revised to provide for two clarifications. First, the paragraph was revised to make clear that it applies to same-sex married couples. Second, certain revisions were made to clarify that paragraph (f) provides that, upon the avoidance of a qualified disposition, the sole remedy of a creditor of one or both spouses regarding property held in the trust that was a tenancy in the entirety before it was transferred to the trust is to obtain a court order directing the trustee to transfer the property to both spouses as tenants by the entirety.

Paragraph (1) of Section 3592 was revised to prevent the failure of a governing instrument to effectively dispose of all or a portion of the principal or income of an inter vivos trust from qualifying as a valid APT in certain circumstances. In general, paragraph (1) of Section 3592 provides that, upon the death of a trustor of an inter vivos trust, if a governing instrument fails to dispose of trust assets, such assets pass under the terms of the trustor’s will or, if he or she has no valid will, pursuant to the terms of Section 501 *et seq.* of Title 12 (“Delaware’s intestacy statute”). Paragraph (2) of Section 3592 provides that if at any time other than the death of the trustor of an inter vivos trust, a governing instrument fails to dispose of trust assets, such assets pass pursuant to the terms of Delaware’s intestacy statute. The revision to paragraph (1) of Section 3592 provides that if, upon the death of the trustor of an inter vivos trust that is an APT, a governing instrument fails to dispose of trust assets, then paragraph (2), not paragraph (1), will govern the distribution of such assets. This revision ensures that the failure of a governing instrument to provide for the disposition of assets on the trustor’s death does not constitute a reversionary interest in the trustor. Because the Qualified Dispositions in Trust Act does not expressly permit the trustor to retain a reversionary interest, the application of paragraph (1) of Section 3592 to an APT on the death of the trustor of the APT could, arguably, disqualify the trust from being a valid APT on the death of the settlor without this revision.

## Trustee Accountings (12 Del. C. §§ 3521, *et seq.*)

Trust Act 2014 made numerous revisions to several statutes in Chapter 35 pertaining to trustee accountings. Most notably, Senate Bill 156 added Section 3521, which was subsequently renumbered to Section 3526 and revised as part of House Bill 412, to provide a mechanism for the waiver of trustee's obligations to file accounts with the Delaware Court of Chancery (the "Chancery Court") in certain circumstances.

### Waiver of Obligation to File Court Accountings

As revised by Trust Act 2014, Section 3526(a) now provides that a trustee who would otherwise be required to file accounts with the Chancery Court under Sections 3521 through 3524 may be released from such obligation, without the approval of the Chancery Court, if the trustee sends a written notice and request for waiver and consent or non-objection, and receives a waiver and consent or non-objection, from each of the "interested parties" to the trust. The contents of the written notice must include (i) a description of the existing statutory filing obligation of the trustee and identification of alternate means by which the trustees will provide beneficiaries with the notice formerly set forth in the account, (ii) a request that the interested person waive the trustee's obligations and consent or not object to the proposed means for disseminating trust information; (iii) a request that the waiver and consent or non-objection be executed by the interested person, his or her attorney ad litem, a person authorized to represent the interested party under Section 3547, or a person authorized by applicable law to represent the interested party in transactions involved with the trust.

Additionally Section 3526(a) requires that each waiver and consent or non-objection is either (i) notarized or (ii) witnessed by a person who is not an interested party. The waiver and consent or non-objection must also include an affirmation that the person executing the waiver and consent or non-objection has read, understood, and been provided with an opportunity to consult with counsel.

Section 3526(b) defines "interested parties" to include the following persons: (i) the trustor, if living, (ii) all living persons who are currently receiving or eligible to receive income distributions from the trust, (iii) without regard to the exercise of any power of appointment, all living persons who would receive principal of the trust if the trust terminated at the time of the notice and all living persons who would receive distributions of income or principal if the interests of all beneficiaries currently eligible to receive distributions of income terminated at the time of the notice, and (iv) all persons acting as an adviser or protector for the trust.

Section 3526(c) provides that, upon compliance with the requirements of Section 3526(a), the trustee is released from its obligations to file accounts under Sections 3521 through 3524 for the duration of the trust. Section 3526(c) further provides that the trustee can be released from its filing obligations for a period shorter than the duration of the trust if a shorter period is specified in the written notice or an order of a court of competent jurisdiction provides otherwise.

Section 3526(d) requires that a trustee provide notice of a release of its obligations under Sections 3521 through 3524 to the Register in Chancery in the county in which the trustee otherwise would have filed its account. Such notice must include as exhibits copies of all of the requisite executed notices and requests for waiver and consent of the interested parties.

### Other Revisions to Sections 3521 through 3525

In addition, Trust Act 2014 revised existing Sections 3521 through 3523 to clarify existing Delaware law. Those Sections are now reorganized as Sections 3521 through 3526.

## Revisions to Power of Appointment Statutes (25 Del. C. §§ 501, *et seq.*)

Trust Act 2014 makes a number of revisions to Chapter 5 of Title 25 of the Delaware Code related to powers of appointment. First, the terminology used to refer to powers of appointment was changed throughout Chapter 5. As a result, the terms powers of appointment are referred to as “general” or “nongeneral” throughout Chapter 5, rather than “limited” or “unlimited”.

Additionally, Section 505 of Title 25 was revised to make the terms of existing Section 505 applicable only to nongeneral powers of appointment and provide new rules related to the exercise of general powers of appointment patterned after the rules found in Section 19.13 of the Restatement of Property (Third) of Wills and Other Donative Transfers (the “Restatement”). Subsection (b) was added to Section 505 to reflect the rule stated in Section 19.13(a) of the Restatement, which provides that the donee of a general power of appointment exercisable in favor of the donee or the donee’s estate may make any appointment of the assets subject to such power that the donee otherwise could make by appointing to the donee or the donee’s estate and then disposing of the appointive assets him or herself as owned property. Subsection (b) expressly contemplates that this rule includes an appointment in trust and an appointment that creates a power of appointment in another. In addition, Subsection (b) applies even if the instrument creating such general power of appointment expressly manifests a contrary intent of the donor.

Subsection (c) was added to Section 505 to reflect the rule stated in Section 19.13(b) of the Restatement, which provides that the donee of a general power of appointment exercisable only in favor of the donee’s creditors or the creditors of the donee’s estate may effectively appoint such assets only to such creditors.

Subsection (d) of Section 505 clarifies that, for purposes of Section 505, the donee of a general power of appointment exercisable in favor of the donee’s creditors or creditors of the donee’s estate and other objects of the power not including the donee or the donee’s estate shall be treated as having two separate powers of appointment – one being a general power of appointment described in Subsection (c) of Section 505 and one being a nongeneral power of appointment described in Subsection (a) of Section 505.

## Reorganization and Clarification of Section 3303(a)

Trust Act 2014 reorganizes and clarifies the provisions of Section 3303(a) of Title 12. Section 3303(a) now provides that the terms of a governing instrument may expand, restrict eliminate or otherwise vary any laws of generally application to fiduciaries, trust and trust administration, including, but not limited to, laws pertaining to:

- (1) The rights and interests of beneficiaries, including, but not limited to, the right to be informed of the beneficiary’s interest for a period of time;
- (2) The grounds for removal of a fiduciary;
- (3) The circumstances, if any, in which the fiduciary must diversify investments; and
- (4) A fiduciary’s powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from that instrument.

## Clarification Regarding Advisers Serving In Nonfiduciary Capacity (12 Del. C. § 3313(a))

Section 3313(a) was revised to provide that the terms of a governing instrument may provide that any adviser, including a protector, shall act in a nonfiduciary capacity. This revision clarifies existing Delaware law.

## Clarification Regarding Fiduciary Responsibility With Respect to Substituted Property (12 Del. C. § 3316)

Section 3316 was revised to provide that if a trustor has a power to substitute property of equivalent value, then the fiduciary responsible for investment decisions has a fiduciary duty to determine that the substituted property is of equivalent value, except as expressly provided for in a governing instrument. The revision makes clear that the provisions of Section 3303 of Title 12, which make almost any provision of a governing instrument enforceable under Delaware law, trump the default rules in Section 3316.

## Elimination of Requirement That Agency Relationship Must Improve Investment Performance or Administrative Efficiency of Trust (12 Del. C. § 3322)

Section 3322(a) permits a fiduciary to appoint an agent for specific purposes if a governing instrument neither affirmatively permits nor expressly prohibits the fiduciary from hiring agents. Previously, such an agent could be hired only if the fiduciary reasonably believed in the exercise of its discretion that such an arrangement was in the best interests of all interested persons and would improve the investment performance or efficiency of the administration of the fiduciary fund. Trust Act 2014 removes the requirement that such an arrangement improves the investment performance or efficiency of the administration of the fiduciary fund, while retaining the requirement that the arrangement is in the best interests of all interested persons.

## Clarification of Decanting Statute (12 Del. C. § 3528)

Certain revisions were made to Subsections (a) and (c) of Section 3528, Delaware's decanting statute, to clarify that an appointment made in further trust under Section 3528 may be made to a further trust for the benefit of an open class of beneficiaries even if the class remains open or might remain open in the new trust beyond the time when the class would have closed pursuant to the terms of the governing instrument of the initial trust; provided that distributions may not be made to members of the class sooner than when, or in excess of the amounts, permitted by the governing instrument of the original trust. The synopsis to House Bill 412 provides an example of a situation falling within the scope of this revision, namely if the initial trust was of limited duration and the further trust was of unlimited duration.

## Clarification and Revision of Law Related to Self-Settled Trusts (12 Del. C. § 3536)

Trust Act 2014 makes certain changes to Subsection 3536(c) that clarify the circumstances under which a trust may be subject to the claims of a trustor's creditors. Subsection 3536(c) generally provides that except as provided in Delaware's Qualified Dispositions in Trust Act, if the trustor is also a beneficiary of a trust, a provision that restrains the voluntary or involuntary transfer of the trustor's beneficial interest shall not prevent such trustor's creditors from satisfying their respective claims from the trustor's interest in the trust to the extent that such interest is attributable to the trustor's contributions to the trust. Trust Act 2014 expanded the interests of a trustor that are excepted from this general rule. Specifically, a trustor shall not be considered a beneficiary for purposes of Subsection 3536(c) if the trustor may be named as an additional trust beneficiary or is a proper object of the exercise of a power of appointment held by someone other than the trustor. Additionally, trustor's creditors may not satisfy their respective claims from the trustor's interest in the trust where the trustor has not retained any beneficial interest in the trust other than either or both: (1) a beneficial interest that is contingent upon surviving the trustor's spouse such as, but not limited to, an interest in an inter vivos marital deduction trust in which the interest of the trustor's spouse is treated as qualified terminable interest property for Federal tax purposes, an interest in an inter vivos marital deduction trust that is treated as a general power of appointment trust for which a marital deduction would be allowed for Federal tax purposes, and an interest in an

inter vivos trust commonly known as a “credit shelter trust” that used all or a portion of the trustor’s unified credit for Federal tax purposes, and (2) a right to receive discretionary distributions to reimburse the trustor’s income tax liability attributable to the trust. Further, a beneficiary of a trust shall not be considered a trustor of the trust merely because of a lapse, waiver, or release of the beneficiary’s right to withdraw all or a part of the trust property.

## Clarification of Protection Available to Successor Trustees Appointed Under a Nonjudicial Settlement Agreement (12 Del. C. § 3544)

Section 3544 provides certain protections to successor trustees with respect to the acts or omissions of predecessor trustees. Trust Act 2014 revises Section 3544 that such protections apply where a successor trustee is appointed pursuant to a nonjudicial settlement agreement entered into under Section 3338, a statute which was recently enacted in Delaware as part of Trust Act 2013.

## Clarification Regarding Application of Virtual Representation to Certain Proceedings to Contest Trusts (12 Del. C. § 3546)

Section 3546(d) was revised to clarify that Delaware’s virtual representation statute (Section 3547) is applicable for purposes of paragraph (a)(1) of Section 3546. Paragraph (a)(1) bars a person from initiating a judicial proceeding to contest the validity of a revocable trust or amendment thereto or an irrevocable trust after the trustee has given such person 120 days’ notice of the existence of the trust. The revision to Section 3546(d) clarifies that Section 3547 would apply to such notice so that the person who receives the notice could virtually represent any person or persons he or she otherwise could virtually represent under Section 3547. This revision clarifies existing Delaware law.

## Revisions Related to the Definition of “Good Faith” and “Trustee” (12 Del. C. §§ 101(2); 3580)

Trust Act 2014 moves the definition of “good faith” from Section 3580 of Title 12 to Subsection (2) of Section 101 to Title 12, which is a Section that contains definitions that apply for the purposes of wills, intestate succession and all other purposes under Title 12. In its place, a definition of “trustee” as such term is used in Subchapter VII of Chapter 35 is inserted as Section 3580. “Trustee” is now defined to include fiduciaries and other persons exercising, or directing the exercise, of trust powers. This definition makes clear that certain provisions in Chapter 35 apply to fiduciaries and to nonfiduciaries, such as direction advisers under Section 3313, that perform or direct others in performance of traditional trustee duties.



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