



## SPECIAL SECTION: TRUST LAW ROUNDUP

By **Todd A. Flubacher** & **J. Zachary Haupt**

### Delaware

New tools for tending an evolving landscape

In June, Delaware enacted its latest installment of annual trust legislation. Trust Act 2019 includes many revisions and clarifications, but two new statutes, Sections 3343 and 3344 of Title 12 of the Delaware Code, represent material advancements in the law. Both statutes grant new trust powers that will help trustees and beneficiaries effectuate a trust's purpose and maximize administrative efficiency. Section 3343 provides that when the terms of a trust instrument give someone the power to appoint a successor trustee, she's now deemed to have the power to appoint multiple successor and additional trustees and to allocate specific trustee powers to one or more of the trustees exclusively and exclude other trustees from having that responsibility. Section 3344 provides that when a trust is taxed as a grantor trust for federal income tax purposes, unless the governing instrument provides otherwise, the trustee may in its discretion (or at the direction of an advisor) reimburse the trustor for the taxes attributable to the ordinary income and capital gains of the trust, even when the governing instrument doesn't expressly authorize such distributions.

#### Section 3343

This section deals with appointing multiple trustees and allocating responsibilities. Absent a contrary provision in the governing instrument, Section 3343 deems any power to appoint a successor trustee to include the power to appoint multiple successor trustees and new

additional trustees to serve together. Moreover, the power to appoint multiple successors and additional trustees is deemed to include the power to allocate various trustee powers exclusively to one or more of the trustees to the exclusion of other trustees. Importantly, for the effective bifurcation of responsibilities, when allocating specific powers to a trustee, it shall be a fiduciary only with respect to those powers, and a trustee who's excluded from exercising powers shall be an "excluded trustee" within the meaning of Section 3313A of Title 12, thus having no liability for the actions of the other trustee and no duty to monitor or advise the other trustee or notify the beneficiaries.<sup>1</sup> Section 3343 allows the individual responsible for changing fiduciaries of a trust administered under Delaware law to divide responsibilities and allocate duties and fiduciary risk across multiple trustees.

Section 3343 is a powerful new concept, but it's a logical evolution of trust law to help trust structures adapt to the modern demands of wealth transfer planning that often involves special assets, complicated taxation, remote situs, changing family dynamics, reliance on directed trust structures, new tools such as decanting and related fiduciary risk concerns. Theoretically, an individual with removal and appointment power could exercise that power as often as she wishes, removing A to appoint B, for a limited period or to accomplish a specific purpose, and then reappointing A or appointing a different trustee altogether. Demanding that a trust must always have a single trustee who performs every trustee function often doesn't align with a trust's needs and seems arbitrary and antiquated. A single trustee is rarely the best performer in every functional area of trust administration, and a single trustee may not be desirable to perform every necessary task and assume all risks.

The concept underlying Section 3343 can be seen as

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analogous to a decanting power being a lesser included power contained within the power to make outright distributions. If someone has the power to appoint successor trustees, then that power could be deemed to include the power to appoint multiple successors or additional trustees and allocate responsibilities among them, subject to the terms and conditions for appointment under the trust instrument. Like the metaphor taught in property law classes, that property rights are like a bundle of sticks and one or more sticks can be removed from the bundle, we can think of the various duties of a trustee as a bundle of sticks, and the individual(s) with the power to appoint successor trustees can hand the entire bundle of sticks to a new trustee and should have the power to remove one or more sticks from the bundle and allocate them to a separate trustee.

The power under Section 3343 is subject to all of the provisions pertaining to the trustee of the trust, including qualifications for appointment, removal and resignation, standard of care and indemnification and compensation. Applicable limitations on the appointment of a trustee like an Internal Revenue Code Section 672(c) related or subordinate limitation, the exclusion of certain individuals, such as the trustor or beneficiaries, or corporate fiduciary capital requirements, tax savings limitations on trustee powers or limitations on the frequency with which the appointment power can be exercised, will all apply to a power exercised under Section 3343.

Section 3343 is available to any Delaware trust and trusts migrated to Delaware causing Delaware law to govern administration. Historically, many irrevocable trusts have been modified using tools such as decanting, merger, non-judicial settlement agreement or consent modification to convert to a directed trust, facilitate administration or alter provisions.<sup>2</sup> These tools generally require the Delaware trustee to exercise discretion or participate in a settlement agreement. In many cases, Section 3343 will replace trust modification or can be used to allocate decanting responsibility to a trustee who won't require beneficiary releases and indemnification (perhaps avoiding potential tax concerns and

fiduciary risk impediments).

The statute can be used to appoint an "administrative trustee" with responsibility for administrative functions necessary to establish nexus for governing law and situs.<sup>3</sup> It could be used to appoint a "tax trustee" that will arrange for the preparation of returns with the preferred accountant or take certain positions or defend against the Internal Revenue Service. A "special litigation trust-

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ee" could be appointed to handle litigation in special circumstances. Additionally, distribution responsibility or decanting powers could be allocated exclusively to a "distribution trustee."

Directed trusts are most commonly used for investments, particularly when family members want to independently control investment decisions, or a trust holds special assets like real estate, limited liability company interests, closely held stock or a concentrated position that conflicts with traditional fiduciary duties to diversify and present corporate fiduciaries with unacceptable fiduciary risk.<sup>4</sup> In such cases, a "special holdings trustee" could be appointed as an alternative to a directed trust



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to retain the special asset and exclude the corporate fiduciary from liability with respect to the asset.

The concept of an “investment trustee” engaging in investment activity directly on behalf of the trust without the corporate trustee’s involvement generally raises practical concerns for corporate trustees because of the potential lack of coordination and information flowing back to the corporate trustee. Consequently, most corporate trustees prefer the directed trust model for investments, in which the trustee executes powers on behalf of the trust but only at the direction of an advisor. Section 3343 could be used to create a directed trust without actually needing to modify the trust instru-

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ment. Co-trustees can be Delaware direction advisors.<sup>5</sup> Section 3343 can create a directed trust structure by appointing a co-trustee with the exclusive authority to make all investment decisions and the power to direct the other trustee and providing the excluded trustee shall exercise all investment powers only on written direction of the co-trustee. This is authorized by Sections 3343 and 3313A and the well-established principles of Section 3313. Additionally, Trust Act 2019 revised the definition of “governing instrument” to expressly include an instrument that allocates trustee powers, duties and responsibilities among co-trustees under Section 3343, thus linking such an instrument to Sections 3313 and 3313A.<sup>6</sup>

New Section 3343 will eliminate the need to modify trusts in many cases. When modifications using decanting and merger are still necessary, Section 3343 can be helpful to assign merger or decanting powers to a new special purpose trustee. Appointment instruments under Section 3343 will require careful drafting to clearly articulate the exclusive duties being assigned to the trustee, effectively limit the role of the excluded trustee, address all facets of the bifurcated relationship and avoid potential ambiguities, risks and pitfalls.

### Section 3344

New Section 3344 deals with income tax reimbursement power. It provides certain trustees with a discretionary power to reimburse a trustor for any amount of the trustor’s personal federal or state income tax liability attributable to inclusion of trust income, capital gains, deductions and credits in the trustor’s taxable income. While other states have enacted statutes that grant a similar power or address the effect on creditors of a power granted by a governing instrument, none of the existing statutes appear to be as comprehensive or protective as Section 3344.

**Background.** The grantor trust rules<sup>7</sup> provide that when a trustor or another person is treated as the owner of any portion of a trust, the items of income, deductions and credits against tax of the trust that are attributable to that portion of the trust shall be included in computing the taxable income and credits of such trustor or other person. These rules can be used to pass wealth to future generations transfer tax free and to decrease a trustor’s taxable estate. While some governing instruments enable a trustor to toggle out of grantor trust status, it isn’t always desirable or advisable to do so. Consequently, circumstances sometimes arise when a trustor may personally incur a substantial income tax liability without sufficient liquid assets to satisfy the liability.

To address this issue, trustors began to include provisions in governing instruments and some states enacted statutes that either enable or require a trustee to reimburse the trustor for the income tax paid by the trustor on account of trust income. Such provisions, however, raised myriad transfer tax and asset protection concerns. For example, many trust professionals harbored concerns that the mere possibility that a trustee could reimburse a trustor for tax payments could cause the entire value of the property of the trust to be included in the trustor’s estate pursuant to IRC Section 2036.

In 2004, the IRS issued Revenue Ruling 2004-64, which addressed: (1) the gift tax consequences of a trustor paying income tax attributable to the inclusion of a trust’s income in the trustor’s taxable income, and (2) the estate tax consequences if, pursuant to a governing instrument or applicable local law, the trustor may or must be reimbursed by the trust for income tax.<sup>8</sup> Specifically, the IRS held:

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When the grantor of a trust, who is treated as the owner of the trust under [subpart E, part I, subchapter J, chapter 1 of the I.R.C.], pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries. If, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under [I.R.C. § 2036(a)(1)]. *If, however, the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includi-*

*ble in the grantor's gross estate (emphasis added).*

Notably, the IRS cautioned that, even with respect to a discretionary reimbursement power, certain facts may give rise to estate inclusion, such as a pre-existing express or implied understanding between the trustor and the trustee regarding the trustee's exercise of discretion, a power retained by the trustor to remove the trustee and name herself as trustee or applicable local law subjecting trust assets to the claims of the trustor's creditors.

Consequently, Rev. Rul. 2004-64 provided trustors and legislatures with a blueprint describing how to structure a reimbursement power while avoiding tax catastrophes. Interestingly, however, few states reacted. Indeed, as recently as 2018, an article in this publication asked, "Where Are All The Grantor Trust Reimbursement Statutes?"<sup>9</sup> With Section 3344, Delaware has answered the call.

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**Provisions.** Section 3344(a) provides, in part, that unless the terms of the governing instrument expressly provide otherwise, if the trustor of a trust is treated under the grantor trust rules as the owner of all or part of the trust, the trustee (other than a trustee who's the trustor or a person who's a "related or subordinate party" with respect to the trustor within the meaning of Section 672(c)) may, in the trustee's sole discretion, or at the direction or with the consent of an advisor (who's not the trustor or a related or subordinate party with respect to the trustor), reimburse the trustor for any amount of the trustor's personal federal or state income

Delaware's statute appears to strike the best balance between granting broad discretion and providing maximum protection to avoid adverse tax consequences.

tax liability that's attributable to the inclusion of the trust's income, capital gains, deductions and credits in the calculation of the trustor's taxable income.

Because Section 3344(a) grants a discretionary power, the statute falls squarely within Rev. Rule 2004-64's proclamation that the existence of such a power, alone, won't cause estate inclusion. Delaware's statute provides even greater protection by limiting the trustees who may exercise such discretion with reference to Section 672(c).<sup>10</sup> This addition to the statute should obviate concerns regarding the imputation of a trustee's power on the trustor and assist in avoiding one of the potential pitfalls described by the IRS in Rev. Rul. 2004-64.

Section 3344 is unique in other respects as well. For example, Section 3344(a) accounts for the proliferation of the directed trust structure in Delaware by expressly permitting an independent advisor to direct the trustee with respect to the exercise of the power, when used in conjunction with new Section 3343 or other Delaware

provisions that permit the bifurcation of trust powers.

Unlike other states' statutes, Section 3344(a) also provides that the trustee may pay such amount directly to the trustor or to an appropriate taxing authority on the trustor's behalf. This provision of the statute avoids potential creditor issues by enabling a trustee to ensure that a trustor's tax liabilities are satisfied by the reimbursement. Section 3344(a) further provides that neither the trustee's reimbursement power nor the exercise of such power shall cause the trustor to be treated as a beneficiary of the trust for any purposes under Delaware law, including Delaware's spendthrift statute, which again assists in avoiding a potential pitfall described by the IRS in Rev. Rul. 2004-64. While Delaware's spendthrift statute, Section 3536, already included spendthrift protection when the terms of a governing instrument include a tax reimbursement provision, Trust Act 2019 updated the spendthrift statute to expressly include protection for the statutory reimbursement power under Section 3344.<sup>11</sup>

Unique to Delaware, Section 3344(a) includes a provision that prohibits the use of income derived from a policy of insurance on the trustor's life held in the trust, the cash value of any such policy and the proceeds of any loan secured by an interest in the policy from being used to reimburse the trustor or to pay an appropriate taxing authority on the trustor's behalf. This provision of the statute should obviate an argument that the reimbursement power over a trust that owns life insurance on the life of the trustor might amount to an "incidence of ownership," which could cause the property of the trust to be included in the trustor's estate under IRC Section 2042.

Finally, Section 3344(b) provides that the reimbursement power granted under subsection (a) shall not apply to a trust if the application of this section to a trust would reduce a charitable deduction otherwise available to any person for state or federal income, gift or estate tax purposes. This provision ensures that contributions to a trust that would otherwise qualify for a charitable deduction won't fail to qualify for such a deduction due to the existence of the power to invade the principal of the trust.

Although a handful of other jurisdictions, such as Colorado, New Hampshire and New York, have enacted statutes that expressly provide a trustee with a



reimbursement power, Section 3344 is unique.<sup>12</sup> For example, none of the other enabling statutes include provisions to address potential concerns related to “incidence of ownership” related to life insurance. Moreover, New York’s statute limits the reimbursement power to capital gains from principal.<sup>13</sup> Consequently, Delaware’s statute appears to strike the best balance between granting broad discretion and providing maximum protection to avoid adverse tax consequences.

A number of states have enacted statutes that don’t expressly grant a reimbursement power, but rather address the effect of including such a power in a governing instrument. Most such statutes provide for some variation of protection from the trustor’s creditors in an effort to avoid one of the pitfalls described in Rev. Rul. 2004-64.<sup>14</sup> Although these statutes are helpful when the governing instrument contains a reimbursement power, they don’t help trustors of trusts without a reimbursement provision who are faced with a potential income tax liability they can’t satisfy and no way to toggle out of grantor trust status. Moreover, it may be impossible to modify the trust to add such a power depending on the tools available under applicable local law and concerns surrounding the possible addition of a beneficiary to the trust.

The tools offered by Delaware’s 2019 legislation are logical and inevitable evolutions of trust powers to address an expanding and increasingly complex trust landscape that’s emerging throughout the country. 🌐

## Endnotes

1. See 12 Del. C. Section 3313A.
2. See 12 Del. C. Sections 3528, 3325(29), 3338, 3342; see also Vincent T. Thomas and Justin P. Duda, “Delaware’s Modification by Consent Statute,” *Trusts & Estates* (April 2018); Dawn S. Markowitz, “When Beneficiaries Want to Modify Trustees’ Duties,” *Trusts & Estates* (June 2014); Richard M. Morgan, “Factors to Consider When Contemplating Trust Modification,” *Trusts & Estates* (September 2018); Dawn S. Markowitz, “Trust Consolidation,” *Trusts & Estates* (January 2015); Charles A. Redd, “Don’t Overlook the Power of Powers,” *Trusts & Estates* (September 2016); David A. Diamond, “The Administration of Quiet Trusts and Decanting Trusts,” *Trusts & Estates* (September 2016); Charles A. Redd, “Decanting Dilemmas,” *Trusts & Estates* (March 2018); William F. Messinger and Arden O’Connor, “Rethinking Trustee Responsibility for Addicted Beneficiaries,” *Trusts & Estates* (March 2018); Joshua S. Miller and Michael Sneringer, “Fiduciary Law Trends,” *Trusts & Estates* (May 2018); Bruce D. Steiner, “Decanting Trusts to Remove Unwanted Beneficiaries,” *Trusts & Estates* (June 2019); Al W. King III, “Decanting is a Popular Strategy, but Don’t Ignore Several Key Considerations,” *Trusts & Estates* (August 2018); Beth D. Tractenberg, “Decanting From Irrevocable Trusts,” *Trusts & Estates* (August 2011); Todd A. Flubacher and Kenneth Hunt, “The Non-Judicial Settlement Agreement Wrapper,” *Trusts & Estates* (January 2014).
3. See *Lewis v. Hanson*, 128 A.2d 819, 826 (1957), *aff’d sub nom. Hanson v. Denckla*, 357 U.S. 235, *reh’g denied*, 358 U.S. 858 (1958). Many trusts use an “administrative trustee” to fulfill the administrative functions within Delaware necessary to clear the *Lewis v. Hanson* test.
4. See Todd A. Flubacher, “Directed Trusts: Panacea or Plague?” *Trusts & Estates* (February 2015); Charles A. Redd, “Directed Trusts—Who’s Responsible?” *Trusts & Estates* (September 2015); Daniel F. Lindley, “Shielding PTC Directors From Fiduciary Risk,” *Trusts & Estates* (May 2017); Al W. King III and Pierce H. McDowell III, “Selecting Modern Trust Structures Based on a Family’s Assets,” *Trusts & Estates* (August 2017); Joseph F. McDonald, III, “Emerging Directed Trust Company Model,” *Trusts & Estates* (March 2012); Al W. King III and Pierce H. McDowell, “Delegates vs. Directed Trusts,” *Trusts & Estates* (August 2006); Todd A. Flubacher and David A. Diamond, “The Trustee’s Role in Directed Trusts,” *Trusts & Estates* (December 2010).
5. See 12 Del. C. Section 3313A(a)(1) (providing that “If the terms of the governing instrument confer upon the cotrustee the power to direct certain actions of the excluded trustee, the excluded trustee must act in accordance with the direction and shall have no duty to act in the absence of such direction and is not liable, individually or as a fiduciary, for any loss resulting directly or indirectly from compliance with the direction unless compliance with the direction constitutes wilful misconduct on the part of the directed cotrustee”).
6. 12 Del. C. Section 3301(e).
7. Internal Revenue Code Section 671 et seq.
8. Revenue Ruling 2004-64 (July 6, 2004).
9. Kim Kamin, “Where Are All the Grantor Trust Reimbursement Statutes?” *Trusts & Estates* (January 2018).
10. IRC Section 672(c) assumes that “related or subordinate parties,” as defined therein, are subservient to the trustor, which can cause powers possessed by such persons to be imputed to the trustor.
11. 12 Del. C. Section 3536(c)(2).
12. See, e.g., Colo. Rev. Stat. Ann. Section 15-5-818 (West 2019), N.Y. Est. Powers & Trusts Section 7-1.11 (McKinney 2015), N.H. Rev. Stat. Ann. Section 564-B:8-816.
13. N.Y. Est. Powers & Trusts Section 7-1.11 (McKinney 2015) (“trustee ... may, from time to time, pay from principal to the creator of such trust an amount equal to any income taxes on any portion of the trust principal with which he is charged”).
14. See, e.g., Ariz. Rev. Stat. Ann. Section 14-10505 (2013); Fla. Stat. Ann. Section 736.0505 (West 2010); Idaho Code Ann. Section 15-7-502 (West 2015); Ky. Rev. Stat. Ann. Section 386B.5-020 (West 2010); Md. Code Ann., Est. & Trusts Section 14.5-1003 (West 2015); N.C. Gen. Stat. Ann. Section 36C-5-505 (West 2017); Tex. Prop. Code Ann. Section 112.035 (West 2017), Va. Code Ann. Section 64.2-747 (West 2012).