

Taking Advantage of Delaware Trust Laws

For many wealthy families, establishing trusts to transfer assets from one generation to another is a central component of a long-term legacy plan. Yet trusts — and the laws that govern them — are often complex, making it challenging to extract the full benefits they offer. Delaware’s sophisticated and progressive trust laws make it easier. Delaware offers investment and administrative flexibility, enhanced tax savings, wide-ranging planning options, and a trust-friendly court system.

Bessemer Trust Company of Delaware, N.A. was established to complement Bessemer’s comprehensive wealth management services by giving clients access to Delaware’s attractive trust laws. Having been founded nearly 100 years ago as a trust company, Bessemer Trust is uniquely positioned to meet your legacy planning needs. Approximately 25% of assets under our supervision are held in irrevocable trusts — evidence, in our minds, of our commitment to serving as a trusted adviser to our clients and their families over multiple generations. Bessemer’s reputation attracts top-tier talent, allowing us to build a dedicated team of professionals, including lawyers, accountants, and trust specialists, focused exclusively on providing superior trust services.

Working closely with families and their advisers, we strive to understand each client’s unique needs and provide tailored comprehensive wealth solutions that evolve as the family evolves. In addition, Bessemer Trust is well suited to deliver thoughtful, objective advice as a corporate trustee. As a trustee or co-trustee, Bessemer Trust is responsible and accountable typically for:

- Safeguarding and valuing trust assets;
- Overseeing asset allocation decisions and investing the trust assets;
- Evaluating and making distributions, either mandatory or discretionary, based on the wishes of the grantor;
- Maintaining regular communication with the beneficiaries and interested parties;
- Handling all record-keeping; and
- Preparing and filing any necessary accounting and tax returns.

The services of Bessemer Trust Company of Delaware, N.A. are available to existing as well as new clients and our Delaware professionals can work together with a client’s local client account team. The Delaware venue draws on the best thinking and resources of the entire firm, including legal and investment expertise.

Greater Flexibility

Among the many attractive features of Delaware’s trust laws is the statute that requires the wishes of the grantor be respected and followed. In practice, this means the terms of a trust may expand, restrict, eliminate, or otherwise define:

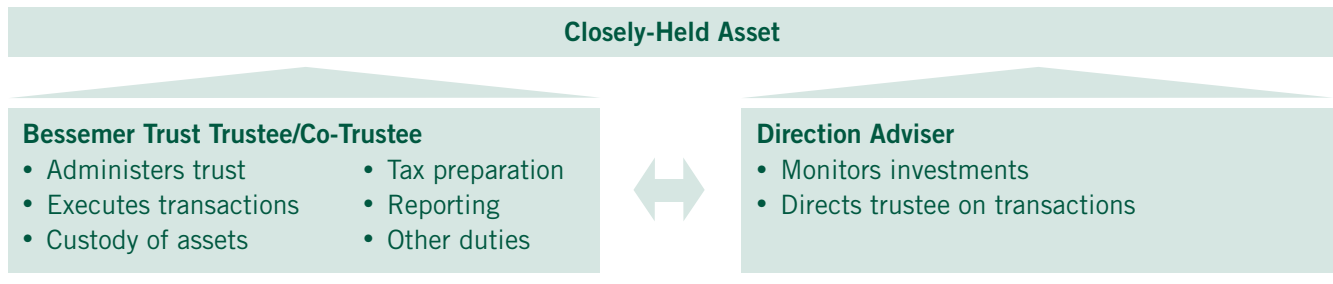
- 1) The rights of the beneficiaries;
- 2) The grounds for removal of a fiduciary; and
- 3) The fiduciary’s powers, duties, and standard of care.

Together, these provisions provide maximum flexibility in achieving the grantor’s intent with respect to investments. The trustee may utilize outside investment advisers to hold illiquid or concentrated positions that a trustee under the Uniform Prudent Investor Act (UPIA), which has been adopted by many states, might otherwise feel required to diversify. In an effort to preserve the maximum freedom for a grantor to establish investment guidance within a trust instrument, Delaware declined to adopt the UPIA.

Delaware law takes this concept a step further than most other states by recognizing “directed trusts,” which provide for an “adviser” that is empowered to direct the trustee with regard to investments (and/or distributions). In effect, this allows for the separation of specified trust functions from the trustee’s administration responsibilities. A direction adviser may be a close associate, a beneficiary, a co-trustee, an officer of a closely-held business held in the trust, or in certain circumstances, even the grantor.

As an example, consider the scenario in which a grantor is the owner of a family business. As illustrated in Exhibit 1, the grantor can place this asset in a trust and appoint a direction adviser to oversee the management of the family business for the benefit of future generations. In

Exhibit 1: A Directed Trust



doing so, he can relieve the trustee of responsibility for diversifying or even monitoring the investment.

As an alternative, for families wishing to hold an interest in a private business for future generations but wanting some active monitoring by a corporate trustee, Bessemer Trust is willing, as trustee, to monitor a closely held business position using the capabilities of our Family Company Advisory Group. We are also willing to monitor concentrated stock positions held in trust. In both cases, appropriate language in the governing instrument evidencing the grantor’s intent would be required.

In addition to monitoring and assessing the valuation of business assets in trust, Bessemer’s Family Company Advisory Group offers a broad range of advisory services and transaction expertise including assistance with: 1) strategic planning, corporate governance assessments, and succession planning; 2) valuation analyses, strategic transitions (e.g. recapitalizations, ESOPs, and redeployment of assets) as well as initial public offerings and other capital raising alternatives to generate liquidity while retaining family control; and 3) partial or complete family exits through strategic partnerships, divestitures, or the sale of companies.

Favorable Tax Laws

Taxes can substantially erode the wealth ultimately passed between generations. In addition to federal income, capital gains, estate, gift and generation-skipping transfer taxes, many states are imposing an ever increasing tax burden on wealthy families and individuals. Delaware helps protect trust assets by not imposing state income tax on an irrevocable trust’s undistributed income and capital gains attributed to non-resident beneficiaries — allowing for greater growth potential of the trust assets over time.

Importantly, Delaware does not seek to substitute this “lost” revenue through indirect taxes. There is no intangible personal property tax, ad valorem tax, franchise tax, gross receipts tax, inheritance tax, estate tax, generation-skipping transfer tax, or gift tax. In most cases, no Delaware tax, of any type, will be due from such trusts.

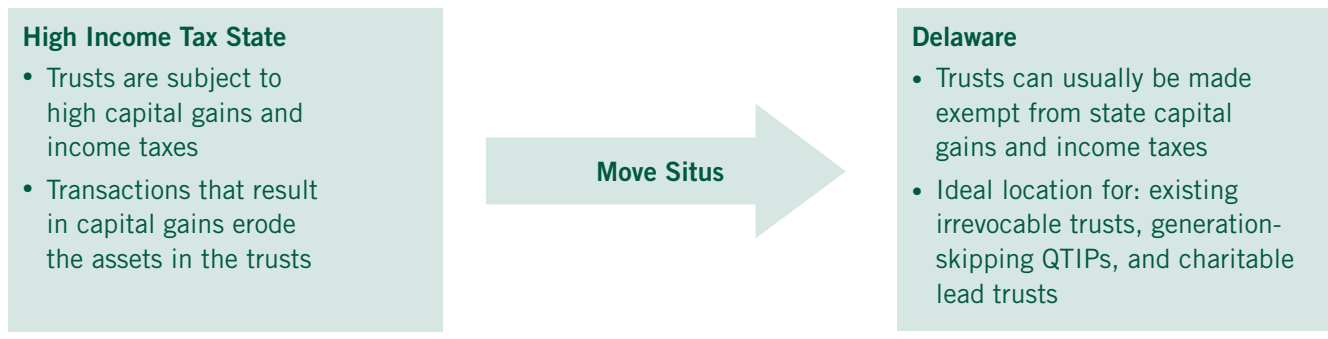
The tax savings can be significant. Consider a trust that sells stock yielding \$1 million in long-term capital gain. Assuming the beneficiaries are non-Delaware residents and the trust is subject to the Alternative Minimum Tax, a trust originally subject to high income tax in states such as California, New York, and New Jersey can potentially save roughly \$75,000 to \$100,000.

Delaware’s favorable tax treatment makes it a compelling location for many existing irrevocable trusts. It is often possible to move a trust from a high income state to Delaware to reduce the tax burden without significant cost or complications (Exhibit 2). Careful planning — with close attention to administration — must be performed to ensure the move is legally recognized by both states.

Trust-Friendly Court System

Delaware has a long history of well reasoned court rulings and it has consistently demonstrated its commitment to safeguarding the advantages of Delaware’s laws.

All trust administration and trust interpretation cases are exclusively within the jurisdiction of Delaware Court of Chancery, and upon appeal, the Delaware Supreme Court. The Court of Chancery, whose jurisdiction is limited to corporate and fiduciary matters, is widely recognized as knowledgeable, effective, and responsive to unusual situations, especially those involving complex financial matters. Specialized judges decide all disputes without jury participation. Court proceedings

Exhibit 2: Moving an Existing Trust to Delaware

are typically handled in a timely, cost-efficient and, if requested, confidential manner.

A premium is placed on confidentiality throughout the court system. Unless asked, Delaware courts do not supervise the administration of trusts. The state does not require any court filings, public registrations, annual meetings, or court accounting for inter vivos trusts and many testamentary trusts. If registered voluntarily, only the name of the trust and trustee must be disclosed; in certain circumstances, informing the beneficiaries may not be required. In the event a dispute arises, the parties can easily obtain a court order to seal the record, keeping the trust agreement, the parties, and their dispute behind closed doors.

Managing the Tension between Beneficiaries

The interests of trust beneficiaries are often at odds. Frequently, current beneficiaries would like to see the distributions maximized, while future beneficiaries want to preserve and grow the assets. As a result, friction may develop over how the trust is invested. For example, the current beneficiary may favor a higher weighting toward bonds to generate income but the future beneficiary may prefer a higher stock allocation for long-term appreciation.

In an effort to ease the inherent tension between beneficiaries, Delaware was among the first states to adopt legislation that allows for the creation of total return unitrusts. Rather than distributing only income from the trust, a total return unitrust distributes between 3-5% of the trust's assets each year. This allows for greater investment flexibility and better aligns the interests of the beneficiaries, as both current and future beneficiaries share the risk and return of the trust assets.

Delaware also allows a trustee to adjust between principal and income — often referred to as the power to adjust — to the extent that the trustee considers appropriate to invest for total return but also treat current and future beneficiaries equitably. In other words, a trustee can distribute trust principal as well as dividend and interest income to the current beneficiary. Before exercising the power to adjust, Bessemer normally would consider a number of factors, including:

- Intent of grantor;
- Identity and circumstance of beneficiaries;
- Needs for liquidity, regularity of income, and preservation and appreciation of capital; and
- Sustainability of the distribution.

Charitable Remainder Trusts

A charitable remainder trust (CRT) is an estate-planning tool that allows a grantor to contribute assets to an irrevocable trust, designate a beneficiary to receive annual payouts during the life of the trust, and give the assets that remain at the end of the trust term to charity. The grantor receives an income tax deduction for the present value of the charity's interest in the CRT, and all income realized from transactions within the trust are deferred from tax until distributions are made to the non-charitable beneficiary — making it an ideal place to diversify a concentrated holding.

A variant of a CRT is a “net income with makeup charitable remainder unitrust” or NIMCRUT. In this case, the beneficiary receives the lesser of the specified unitrust amount or the trust's net income, with any shortfalls (the “makeup amount”) paid in subsequent years. This type of trust is particularly useful when the grantor or beneficiaries want to defer payments, and thereby income tax

recognition, from the trust until later years. A NIMCRUT can invest in vehicles such as common trust funds, LPs, or LLCs, which retain income generated within the investment vehicle. Under Delaware law, if the trust provides that no “net accounting income” is generated until such vehicles make distributions, are sold, or are redeemed, the trustee will not have to make a distribution from the trust until such events occur. This allows the assets in the NIMCRUT to grow free of taxes, while permitting rebalancing and investment changes within the investment vehicle itself, and affords substantial control over the timing and extent of trust distributions in the future.

Perpetual Trusts

Many states place a limit on the number of years a trust can exist, commonly referred to as a “rule against perpetuities.” The common law rule against perpetuities limits the duration of a trust to approximately 80-100 years. This may prevent distant generations from benefiting from a trust despite the wishes of the grantor. In 1995, Delaware abolished its rule against perpetuities for assets other than real estate held directly by the trust, permitting the creation of trusts with no artificial time limits (sometimes called “dynasty trusts”). The assets in such a Delaware trust may remain free of estate, gift, and generation-skipping transfer taxes for an indefinite time period. There is a 110-year limit for trusts that directly own real estate interests. In the event the trust owns a real estate interest through an intervening entity, such as an LLC, this limitation does not apply.

Additional Advantages

For many of the reasons expressed above, Delaware is an attractive jurisdiction for trusts established by non-U.S. clients. In some cases, a U.S. jurisdiction can provide significant tax advantages for citizens of other countries who are not U.S. residents, and the United States provides both security and a low tax jurisdiction for many such non-U.S. persons.

Delaware statutes also allow for discretionary distributions back to the grantor while providing some measure of protection of the assets in trust from most creditors. We do not recommend the creation of such “Asset Protection Trusts” for this purpose alone.

Setting up a Delaware Trust

There are many compelling reasons why it may make sense for a wealthy family to consider utilizing a Delaware trust as part of their legacy and tax plans. If you are interested in learning more and discussing whether a Delaware trust would be appropriate for you, please call Bessemer Trust Company of Delaware, N.A. or your local Bessemer Trust office.

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