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The Flexibility and Freedom of a Delaware Directed Trust

When you need a trust, but want to or must maintain control

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Key points

- A trust can be an effective vehicle to transfer wealth to the next generation or to help protect assets from creditors
- A directed trust can provide a family with the flexibility and freedom they need to overcome many hurdles in their trust and estate planning process
- Delaware directed trusts are flexible tools that allow various aspects of the trustee's discretion to be controlled by outside advisors

While many other states have adopted directed trust laws in recent years, establishing this type of trust in Delaware has additional advantages.

Estate planning for high-net-worth families frequently requires the use of trusts. But relinquishing investment decisions to a trustee is not a comfortable or practical choice for some families. Fortunately, Delaware trust law provides a solution to this problem through directed trusts.

Today, many high-net-worth families find that their wealth is concentrated in a particular investment or sector. It may be a function of having a family business, specific expertise in a single sector, such as real estate, or a relatively heavy weighting in alternative investments, such as hedge funds or private equity. While these assets may have served the family well in creating wealth, they can present difficulties in implementing effective estate planning or asset protection strategies.

A trust can be an effective vehicle to overcome these obstacles and transfer wealth to the next generation or to help protect assets from creditors. However, a concentration of assets in a particular investment or sector may present a significant obstacle to the use of trusts. The most common stumbling block is the tension between a trustee's fiduciary duty to diversify a trust's investments and a family's desire to retain concentrated holdings of legacy stock, real estate, or other assets, such as a closely held business, hedge funds, or private equity, that are less transparent and can be difficult to manage and value. In addition, many families want to maintain control over the investment process or retain trusted investment advisors regardless of a trust's investment mix.

Virtually every state's trust law allows a trustee to delegate its investment responsibilities to an investment advisor. But delegation is not the same as direction. When a trustee delegates to an investment advisor, the trustee typically remains liable for the performance of that advisor and, therefore, monitors investment decisions. Thus, delegation of a trustee's investment responsibilities often is not an effective planning option for these types of assets.

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Delaware's distinction

In Delaware, it's different. The state's distinctive trust law allows someone living anywhere in the United States, or the world, to create a Delaware trust funded with the types of unique assets described above. The specific feature of Delaware's law is often referred to as a "directed trust."

Delaware's directed trust law provides the:

- Freedom to engage in estate planning or asset protection planning using illiquid assets, such as stock in the family business, real estate, or hedge fund/private equity investments;
- Flexibility to retain control over a trustee's discretion regarding investments or distributions so that a trusted advisor or family member can do what is best for the family/beneficiaries; and
- Ability to override a trustee's traditional duty to diversify a trust's assets in situations where the family wants to keep a concentrated position in a legacy stock, the family's real estate holdings, or the family business.

Source: https://delcode.delaware.gov/title12/c033/index.html

Under Delaware's directed trust law, a trust agreement may be drafted so that an advisor, who is appointed in the agreement, is given the authority to direct the trustee regarding discretionary investment decisions. This law relieves the trustee from virtually all liability for decisions in which it is directed by an advisor. By removing investment decisions from the trustee, the tension between a trustee's duty to diversify assets and the family's desire to plan using concentrated or difficult to manage assets can be obviated. The result is the freedom and flexibility to implement almost any wealth planning strategy that employs a trust—asset protection trusts, dynasty trusts, marital trusts, credit shelter trusts, charitable remainder and lead trusts, intentionally defective grantor trusts, grantor retained annuity trusts, etc.—to help as you work toward achieving your desired goals.

Finally, a directed trust refers to how a trust is administered, not a specific type of trust planning vehicle. It is a feature that may be added to virtually any type of trust structure in Delaware.

Added flexibility beyond investment decisions

Beyond investments, Delaware's directed trust law allows virtually every discretionary decision traditionally held by a trustee to be controlled by an advisor appointed in the trust agreement. These discretionary decisions include choices regarding when and how to make distributions to beneficiaries (the "distribution advisor"); the hiring and firing of investment managers (the "investment advisor"); the removal and appointment of trustees (the "trust protector"); and when and how to change or diversify a trust's investment holdings. When a majority of the discretionary decisions are controlled by advisors, the trustee is referred to as an "administrative trustee," since its role is limited to carrying out the administrative functions of a trustee—record keeping, tax return preparation, and maintaining custody of the trust's assets.

While Delaware's directed trust law is very powerful, it cannot remove every impediment to using a trust. In addition to issues related to fiduciary liability and control, execution of a trust may have estate, gift, and income tax consequences. Use of family members as the advisors who direct a trustee may cause unintended tax consequences. As a result, great care must be exercised when creating a trust that will use a family member or other non-independent individual as an advisor.

Moreover, it is important to be sure that all the parties understand their roles and responsibilities when the components of a trustee's duties are split among the trustee and one or more advisors. It is also helpful to have a plan for dispute resolution. And if a committee of advisors is appointed for investments or distributions, it is important to think about a governance strategy.

Most common uses of directed trusts

There are many common uses for directed trusts. These include:

Dynasty trusts

A dynasty trust is a long-term trust created to pass wealth from generation to generation without incurring transfer taxes. A common planning strategy is to fund a perpetual dynasty trust with an amount up to the lifetime gift tax exemption amount. Because the transfer to the trust is exempt from estate, gift, and generation-skipping transfer taxes, the trust's future growth is free from those taxes. In effect, the trust creates an endowment fund for future generations. A dynasty trust is typically funded with assets expected to appreciate, such as investment assets, stock in the family business, real estate, and/or profit interests in hedge funds or private equity investments. By making the trust a directed trust, the family

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Adding a directed trust feature to the desired trust structure would allow the family member or trusted advisor to continue to control the investment of the family's assets while they are held in trust.

may designate one or more advisors to make investment decisions with regard to such unusual assets, while having an administrative trustee perform the other duties of a trustee.

Asset protection planning

In 1997, Delaware was among the first states to allow the creator of a trust, known as the "settlor," to remain as a beneficiary and to have the trust assets protected from the claims of the settlor's creditors. Such a trust is called an "asset protection trust," or APT. Often, the assets the settlor is trying to protect are not a well-diversified, liquid portfolio of stocks easily managed by a corporate trustee. By using a directed trust in Delaware, however, virtually any type of asset may be put in an APT to be protected from creditors. Since the investment responsibility is removed from the trustee, any tension over the investment mix can be eliminated.

Keeping a trusted advisor

Directed trusts may be used in many situations where a family member or long-term advisor has investment expertise that the family believes is superior to the investment advice that may be provided by the trustee. Many families who have created their wealth through the investment expertise of a family member or trusted investment professional would like to continue the use of the advisor's services while employing the benefits of a trust to further their estate planning or asset protection goals. Adding a directed trust feature to the desired trust structure would allow the family member or trusted advisor to continue to control the investment of the family's assets while they are held in trust.

Trusts with flexible income and distribution provisions

It is typically difficult to foresee the needs of future generations of beneficiaries. So in planning for perpetual trusts, it can be helpful to provide for flexible distribution provisions. By appointing a distribution advisor (or committee) who is close to the family, families can be sure that distribution decisions are made by an advisor who can take into account their needs and values.

Legacy trusts (including existing non-Delaware trusts)

A directed trust may also be a solution if an existing trust requires or would benefit from a corporate trustee, but the family is not satisfied with the investment or distribution decisions made by the corporate fiduciary. Whenever a family seeks to change an existing trust, of course, it must obtain legal advice, and the changes may require court approval. In many cases, however, it is possible to move an existing trust to Delaware and reform it to help accomplish the family's objectives.

Delaware directed trusts are flexible tools that allow various aspects of the trustee's discretion to be controlled by outside advisors. In the end, a directed trust may provide a family with the flexibility and freedom they need to overcome many hurdles in their trust and estate planning process.

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As part of the Wilmington Trust Emerald Family Office & Advisory® team, Jeff is responsible for developing trust planning strategies for successful individuals and families throughout the United States and abroad. He works closely with his clients' legal, tax, and investment advisors to construct and implement appropriate trust structures that take advantage of the state of Delaware's unique trust and tax laws. He earned his JD (summa cum laude) and MBA (with honors) from Syracuse University and holds a bachelor's degree in economics from Northwestern University.