Let's talk

Asset protection for tax-exempt organizations: Delaware Asset Protection Trusts

Tax-exempt organizations are increasingly concerned about preserving assets for charitable purposes and protecting them against loss to creditors, particularly in light of today's increasingly litigious society. Assets owned in the name of the exempt organization or in a corporation created by the tax-exempt and certain endowments and foundations generally enjoy minimal, if any, protection from creditors. Transfer of assets to a Delaware Asset Protection Trust can offer incomparable creditor protection.

Key takeaways:

- Delaware Asset Protection Trusts can offer tax-exempt organizations a higher level of creditor protection than traditional asset protection vehicles.
- The exempt organization can receive distributions from the trust for its charitable purposes and retain control of the investment of trust assets.
- Tax-exempt organizations and their advisors should consider the use of a Delaware Asset Protection Trust to protect assets from future creditors, preserving them for charitable purposes.

Fiduciary duty to protect assets

There is no question that exempt organizations are subject to lawsuits. While every director acts as a fiduciary with the duties of care and loyalty, directors of exempt organizations have a special duty to advance the organization's charitable goals and preserve its assets for charitable purposes.

Exempt organizations have traditionally used limited liability companies (LLCs) and corporations to protect their assets. Such entities created by the exempt organization may protect it from claims arising out of the activities of the LLC or corporation. However, such entities would not protect assets owned by the exempt organization (including the LLC or corporation itself) from claims arising out of the activities of the exempt organization itself. In certain circumstances, assets held in an endowment fund or foundation created for the benefit of an exempt organization may not be reached by its creditors. However, assets contributed by an exempt organization to a self-designated endowment fund generally are not protected.

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Delaware Asset Protection Trusts

Delaware Asset Protection Trusts (DAPTs), although less well known in the exempt organization community, offer a higher level of creditor protection than LLCs, corporations, and self-designated endowments. A DAPT is an irrevocable trust created by the "transferor," often called the "grantor," for the transferor's own benefit that protects the trust assets from the creditors of trust beneficiaries, including the transferor, until the trust assets are distributed. DAPTs have been effectively used by individuals for creditor protection for over 15 years. As a matter of Delaware trust law, an exempt organization can also create a DAPT.

Distributions

In the context of the tax-exempt organization, the organization itself is the sole beneficiary of the DAPT and is eligible to receive distributions for its charitable purposes in the discretion of the trustee. As an attractive alternative, the organization could appoint a distribution committee, comprised of individuals (or at least a majority of individuals) who are not members of the exempt organization's governing body, which has the power to direct the trustee to make distributions from the DAPT.

Investment of trust assets

The organization has two choices for the management of the trust assets. The trust document can give the trustee investment responsibility over some or all of the trust assets. Delaware law also permits the organization to retain the power to control investments. For example, the organization can appoint an Investment Committee comprised of members of its governing body that has the power to control the investment of the DAPT's assets. This is a favorable option for organizations who wish to continue to use current investment managers or to use more than one investment manager.

Federal income tax exemption

The DAPT should be classified as a trust for tax purposes and, when structured as a grantor trust, the DAPT's income should be exempt from federal income tax to the same extent as if the income were earned directly by the exempt organization.

Creditor protection

Under Delaware law, the creditor cannot satisfy a judgment against the organization from trust assets unless the creditor brings action against the trust within four years of its creation AND the creditor proves by clear and convincing evidence that the transfer to the trust was fraudulent. Under Delaware law, a transfer is fraudulent as to future creditors if the creditor proves that the transfer was made with the actual intent to defraud such creditor. A creditor whose claim against the organization arose after the DAPT was created should not be able to enforce the claim against DAPT assets.

Confidentiality

Delaware law provides unsurpassed privacy to trusts governed by the law of Delaware. There is no requirement to file trusts in court and court accountings are not required. So there does not need to be a public record of the trust.

Conclusion

Tax-exempt organizations and their advisors should consider the use of a DAPT to protect assets from future creditors and preserve them for charitable purposes. When compared to traditional strategies such as LLCs, corporations, and endowments, the benefits of a Delaware trust are unparalleled in terms of asset protection, control and confidentiality.

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