delaware banker

Summer 2022
Vol. 18 No. 3

Special Needs Trusts and ABLE Accounts

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Delaware Banker welcomes news items from members of the Delaware Bankers Association. The Editors reserve the right to refuse any advertising or editorial copy deemed unsuitable for publication. The Editors reserve the right to set the publication date in accordance with the Association's needs. Direct submissions to Greg Koseluk at greg.koseluk@debankers.com

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View from the Chair

by
Dominic C. Canuso
EVP & Chief Financial Officer
WSFS Bank

Chair
Delaware Bankers Association

"Collaboration across the entire organization will ensure a better view of current market conditions, of customers' expectations, and how best to serve them."

If we were reminded of anything over the past few years, it's that "Change is the only constant in Life." (Heraclitus, c.550 BCE)

After traversing through a 1-in-100-year pandemic that affected all aspects of our lives, including the economy, we are again at another financial markets and economic crossroads. Inflation could remain around 9% for the remainder of the year, the highest since 1981. Gross Federal Debt as a percent of GDP at 123% is the highest since peaking in 1946. GDP growth is on a four-decade decline, while the workforce participation rate is on a two-decade decline. Recession and potential credit risk challenges may be on the horizon.

Yet, at the same time, bank balance sheets have never been stronger from a capital and liquidity position. Banks were the catalyst for executing the PPP response and were seen as stewards of the economy through COVID. Bank liquidity is resulting from unprecedented customer deposit levels across the spectrum: from remaining PPP business funding, to customers who averaged less than $5,000 in their deposit accounts pre-Pandemic having doubled or tripled. Current and leading credit metrics continue to be at historic positive lows, and business investment demand remains high.

In addition, banks have never been closer to their customers' behaviors and needs through Customer Experience departments. Technology innovation and collaboration has never been higher or faster as banks spend over $110 billion annually on technology delivering new systems, products, and features that make Banking easier and faster. Even with the recent 66% pullback in Cryptocurrencies, Blockchain and Real-Time-Payments (RTP) are here to stay. Workforce flexibility has been maintained post-Pandemic, allowing banks the opportunity to hire inside or outside their footprint to attract the best talent. And Diversity, Equity, and Inclusion progress continue to enhance the openness and collaboration at the meeting room tables.

What does this all mean for the economy and our customers going forward? As one Fed President recently said, "throw out your old macro-economic 101 textbook," as it will not be a good indication of what's to come.

Experience continues to matter and will be critical in supporting banks' direction and strategies as history continues to repeat itself. Those that have "been there done that" should share historical best practices and response tactics with the newer generations of bankers. At the same time, newer voices at the table, the younger generations, historically underrepresented minorities, and those more fluent in emerging technologies and customer trends, will be just as critical. Banks, businesses, and employees that embrace change are better positioned to learn, adapt, and react to the shifting environments and market conditions. And collaboration across the entire organization will ensure a better view of current market conditions, of customers' expectations, and how best to serve them.

Banking in Delaware, and the DBA, have long been leaders through the changing financial services landscape. I am sure we will continue to do so going forward.

Dominic

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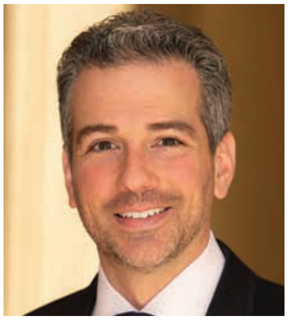

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President's Report

by
Sarah A. Long
President, CEO & Treasurer
Delaware Bankers Association

Alliances play a key role in almost every industry, including financial services. Whatever the objectives of the alliance, being a good partner is a critical corporate asset. Rosabeth Moss Kanter, Professor of Business Administration at Harvard Business School, refers to these fruitful collaborations as a "company's collaborative advantage."

The American Bankers Association and fifty-one autonomous state bankers associations, including the Delaware Bankers Association, collaborate in an alliance representing the collective banking industry. The purpose of the coalition is to promote the varied interests of all of our members and advocate on their behalf. In July, leaders from the alliance met to level-set, strategize and approach the second half of the year with a shared lens.

We heard from a number of terrific speakers, including former U.S. Defense Secretary Ash Carter, who has spent more than three decades leveraging his knowledge of science and technology, global strategy, and policy to make our nation and the world a safer place. He has done so in direct and indirect service of eleven secretaries of defense in both Democratic and Republican Administrations.

Massachusetts Housing and Economic Development Secretary Mike Kennealy shared the Administration's agenda to create economic opportunity for residents, which includes fostering collaborative leadership in communities, an environment that supports job creation and business growth, and housing for residents through targeted investments.

We also had a briefing on Project Hamilton, a joint initiative between the Federal Reserve Bank of Boston and the Massachusetts Institute of Technology. Project Hamilton is a multi-year research project to explore the Central Bank Digital Currency design space and gain a hands-on understanding of a CBDC's technical challenges and opportunities. Ultimately, the decision to create a CBDC is a decision for Washington.

We heard from ABA staff on hot topics like digital assets, climate change, ESG, the 2022 elections, bank workforce recruitment and retention, and the upcoming #BanksNeverAskThat campaign.

But the highlight of the meeting was the gathering at the John F. Kennedy Presidential Library and Museum. President Kennedy was the last sitting president to address an ABA event. In his February 1963 speech to the ABA Symposium on Economic Growth, President Kennedy said, "There is nothing academic about pushing our economy to 4 percent instead of 3 percent, which might total over the next ten years in today's prices $400 billion more in output of goods and services, with all that this would mean to family incomes, wages, profits and governmental revenues. These are the concrete, not abstract, figures that growth represents. That is why I am pleased that the American Bankers Association has devoted this conference to that subject."

As Rob Nichols, President of the ABA, noted, "Nearly 60 years later, that continues to be our north star: accelerating sustainable, inclusive growth that supports the real people and businesses in each one of our communities."

As an alliance, we leverage each other's respective resources while respecting each other's independence, uniqueness, and diversity of members. Working from a foundation of mutual respect, the alliance presents a powerful unified position to achieve a common goal - a strong banking system that creates economic opportunity and brighter futures for all.

All Around the Hall

by
Thomas P. Collins
Executive Vice President
Government Affairs
Delaware Bankers Association

"The DBA will have to be extra vigilant and ever-present to advocate for Delaware's vibrant banking industry and the interests of the business community at large."

The second session of the 151st General Assembly ended June 30th. Though light in adverse banking issues, it was never the less another successful session for the Delaware Bankers Association. With the relaxation of COVID-related restrictions, the experience in Legislative Hall was almost back to normal pre-pandemic conditions. Once again, the sessions were live, and most legislators were present for the sessions. However, the committee hearings were a mix of live and virtual formats. This made it possible for more of the public to participate in the hearing process, although on a limited basis.

Some of the bills we followed are addressed here briefly to provide a flavor of the issues presented during the session.

The Paid Family Leave Act (SB1), sponsored by Senator McBride, is a great example of a bill sponsor willing to work with the stakeholders to achieve a positive, fully negotiated law that affects all businesses with over ten employees. It basically provides for paid leave for employees at 80% of wages for up to 12 weeks. Senator McBride spent dozens of hours listening to the concerns and ideas expressed and explaining why she would accept the proposal or not. The stakeholders' and the sponsors' cooperation resulted in a much-improved bill that could be supported by, or at least not opposed by, the business community, large and small. The Governor signed it in early May and it became effective July 1st.

Data Brokerage bill (HB262), introduced on the last day of the session in 2021, required everyone that collects personal information on Delaware residents and sells or licenses that information to register with the Attorney General's office and respond to questions about what is done with that information. It was opposed by the DBA and the business community as a whole, which had many difficult conversations with the sponsor and her legal support in the Attorney General's office. Believing it was duplicative of existing regulatory privacy responsibilities and unnecessary, the DBA opposed the bill. Because the bill applied to financial institutions covered by the federal Graham Leach Bliley privacy provisions, the DBA sought and eventually received a GLBA exemption from the bill. In return, the DBA changed its position from strongly opposed to neutral. The bill passed the House in early May but languished in the Senate and expired at the end of the session.

The EARNS Act (Expanding Access for Retirement and Necessary Savings) (HB 205) was introduced in late 2021 and championed by our State Treasurer. Designed for small businesses that are unable to offer retirement plans to their employees, the program automatically enrolls employees with the option to opt out. It is a state-sponsored savings plan funded by employees, facilitated by employers, and overseen by the State. Initially concerned with the likelihood of success and the potential expense of launching and supporting the program, the DBA took a neutral position on the bill. With several amendments, it passed the Legislature in late June and will take effect when it is signed by the Governor in late August.

Marijuana was high on the agenda and a huge issue in Dover this past session. There is growing support for the legalization of marijuana, especially among the progressive members of the Legislature. The first bill, HB 305, was defeated in the House in March. Shortly thereafter, two bills, HB 371 and 372, were introduced. HB 371 provided for the legalization, and HB 372 provided for the regulation and taxation of marijuana. HB 371 passed the House and Senate by mid-May and was sent to the Governor. As promised, he vetoed the bill. An attempt to override the veto was defeated in the House. After HB 371 was sent to the Governor, HB 372 was defeated in the House, thus killing the marijuana issue for yet another year. The DBA continues to oppose the bills until changes are made in federal law that permit financial institutions to bank and service marijuana and related businesses.

A bill of apparent minor significance had our focus throughout the session. HB 181 provided for an interest rate cap on certain small loans made by licensed lenders. While it did not directly affect our members, it was deemed a threat to the reputation of the state as a banking-friendly state. Indeed the hallmark of the 1981 Financial Center Development Act was the elimination of interest rate caps resulting in Delaware's spectacular growth in financial services, particularly in credit cards. While the bill made it through the House Banking Committee, with the help of other stakeholders, we were able to keep the bill from coming to the floor for a vote, letting it die at the end of the session.

In Delaware, a notary public is required to notarize documents in person and not remotely. During the pandemic, by executive order of the Governor, special authority was granted to notary publics to enable them to discharge their duties remotely under strict guidelines. We supported SB 262, which extended that process until July 1st, 2023.

Satisfying old mortgages on the public records is important in order to clear title on real estate. To facilitate that, we supported HB 338, which provided for automatic satisfaction of the mortgage ten years after its maturity or 40 years after the recording of the mortgage.

The DBA and the Delaware Bar Association once again collaborated on annual updates to the state's trust laws (SB284) and decedents' estates and fiduciary powers (HB406) to keep Delaware's preeminence in this field of law. As with the Bar's annual update of the corporate and alternative entities statutes, the DBA shares a trusted confidence with the legislature that enables a smooth and reliable process for addressing these annual bills.

In summary, it was a good year for the DBA. However, with the coming election in which every seat in the Legislature is in play, the DBA will have to be extra vigilant and ever-present to advocate for Delaware's vibrant banking industry and the interests of the business community at large.

Tom

What's New at the DBA

New Financial Institution Member

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Whisman Giordano & Associates, LLC is a certified public accounting and business advisory firm in Newark, DE. Since 1973, we've delivered superior accounting, auditing, and tax services. We work with clients as part of their team, helping them obtain the results they seek with a warm, friendly approach and a smile. We use a powerful teamwork approach and develop long-term relationships through open, honest, and respectful communication. Recently, Whisman Giordano has won multiple awards, including the Rush Award from the BBB Serving Delaware, the Delaware Business Times' Family Owned Business Awards Legacy Award, Cleary Rated's Best of Accounting for Client Satisfaction based on feedback from our clients, and national recognition as a "Best Accounting Firm to Work for" by Accounting Today.

DBA 127th Annual Meeting

New DBA Chair, Dominic Canuso, receives congratulations from outgoing Chair, Tom Forrest

Dominic C. Canuso, EVP & CFO, WSFS Bank, was elected the Chair of the Delaware Bankers Association (DBA) on May 12th at the DBA's 127th Annual Meeting at the duPont Country Club in Wilmington. The DBA also elected and installed: Tarrie Miller, President & COO, County Bank, to the position of Chair-Elect.

Mark Lally, the CEO of First State Compassion, delivered the keynote address. After a 20-year career in law enforcement, Mark trailblazed Delaware's medical cannabis industry, creating industry-leading procedures and policies while focusing on delivering the best products and services to thousands of patients every month.

David G. Bakerian Scholarships

DBA President, Sarah Long and Dominic C. Canuso, EVP & CFO, WSFS Bank, congratulate the recipients of the 2022 David G. Bakerian Scholarship. (l. to r.) Sarah Long, Haley Schofield, Concord High School, Janice Castro, Newark Charter High School, and Dominic Canuso.

The Delaware Bankers Association announced the winners of the 2022 David G. Bakerian Award at the 127th Annual Meeting, May 12th. The winners were Janice Castro, a student at Newark Charter High School, and Haley Schofield, a student at Concord High School. Both students participated in the Keys to Financial Success course. Each winner received a $2,500 scholarship.

Benefits of Special Needs Trusts and ABLE Accounts

by
Michael D. Kelly, CPA
and
Karly A. Laughlin, CPA

Belfint Lyons & Shuman, P.A.

It's hard to find anyone who has not been personally impacted or does not know someone that has been affected by a long-term disability. Whether it be a family member, a friend, or themself, easing the impact of a disability on an individual is a common goal that bonds many people. One of the major concerns surrounding a long-term disability is financial stability. Planning for the financial well-being for a person with disabilities is a leading priority for most families. Governmental benefits, such as Supplementary Security Income (SSI) and Medicaid, accomplish some of this, but they are still limited in what they cover. For individuals with a disability who want to retain assets and/or have family who want to gift them assets, there must be proactive planning to ensure those assets minimize the impact on the person's access to governmental benefits.

Let's start with a review of what is generally offered through government assistance.

The Social Security Administration pays monthly SSI benefits to recipients with limited income and resources who are disabled, blind, or age 65 or older. SSI benefits are different than Social Security benefits since they are not based on work history.

The Social Security Administration defines "disabled" for persons older than 18 as being unable to perform any substantial gainful activity along with one of the following two items being true:

- The disabled person's ailment is expected to result in death or
- The ailment has lasted or can be expected to last for a continuous period of not less than 12 months.

If recipients earn more than $1,350 per month, they will fail the substantial gainful activity test and won't be considered disabled by the Social Security Administration.

SSI recipients must meet strict income and resource requirements to qualify for the full benefit. The income and resource tests have extremely low limits which can reduce or eliminate any potential benefit from SSI. For example, a recipient may not be eligible for SSI benefits if their assets are above $2,000. Certain assets, such as the recipient's home or car are excluded from the test. If a recipient earns more than $65 in a month or receives more than $20 from unearned sources, their SSI benefit may be reduced.

In most states, SSI recipients can automatically qualify for Medicaid which will cover hospital stays, doctor bills, prescription costs, and other health care costs. There are additional ways to qualify for Medicaid outside of being an SSI recipient which may allow the individual to have more countable income and assets but there are still low limitations required.

Next let's discuss planning that can be done along with government assistance, specifically Special Needs Trusts and ABLE Accounts.

Special Needs Trusts (SNTs), also known as supplemental needs trusts, which are established to benefit a person with disabilities, are an effective planning vehicle. The assets titled under a SNT agreement can be excluded from the beneficiary's resource tests in qualifying for governmental benefits. A trustee is appointed to be responsible for ensuring that the trust is administered according to the trust agreement. The trustee can be a family member, friend, or a professional advisor.

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SNTs are intentionally designed to provide funds that will enhance the beneficiary's quality of life beyond the benefits that are offered by the government.

There are two types of SNTs.

- First-party SNTs (also known as self-settled trusts) are when the person funds a trust with their own assets for their own benefit. These trusts are commonly created when an individual with a disability receives an inheritance or settlement proceeds. To avoid these assets from counting against the individual for potential government benefits, the trust must be irrevocable, established before the person turns 65, and have a trust agreement that states Medicaid benefits will be reimbursed with any remaining trust's assets at the time of the beneficiary's death or closing of the trust. These trusts are generally classified as grantor trusts which means all the income and deductions from the trust's assets will flow onto the beneficiary's income tax return. The grantor trust structure will most often result in tax savings since the tax brackets for a non-grantor trust compared to an individual are much more compressed, with the top tax rate of 37% starting at $13,451 of taxable income.

- The second type of SNTs are third-party trusts. Third-party trusts are funded by someone other than the individual with disabilities. These trusts are often created during estate planning for the grantor, but the trusts are not actually funded until the grantor passes away. Generally, they do not require Medicaid payback provisions to be included in the trust agreement. Third-party trusts with a deceased grantor are generally taxed as complex trusts. Distributions to the beneficiary will carry out taxable income which will be taxed on the beneficiary's individual income tax return. If there are no distributions, then the trust will pay the tax on the accumulated taxable income.

SNTs, as defined under Section 1917(d)(4)(A) or 1917(d)(4)(C) of the Social Security Act of 1917 are specifically excluded from the resource test mentioned above related to SSI. However, money paid from these trusts directly to the recipient reduces the SSI benefit. Money paid from these trusts directly to someone such as the caretaker which the caretaker then uses to provide the beneficiary with food or shelter will also reduce the SSI benefit but only up to $300.33 per month in 2022. Money paid from these trusts directly to the caretaker to provide the beneficiary with items other than food and shelter do not reduce the monthly benefit. Therefore, trustees and family members must be careful in terms of planning for the distributions from SNTs.

For federal income tax purposes, third-party complex trusts can generally claim a personal exemption of $100. This amount does not have a material impact on a trust's tax liability. However, there is a special exception for SNTs which allows a super-charged exemption of $4,300 (in 2021) which replaces the $100 exemption described above. The exemption is adjusted annually for inflation and is not available for grantor SNTs. For purposes of the enhanced exemption, the definition of the qualified disability trust in the Internal Revenue Code follows the definition described in the Social Security Act of 1917.

One potential hurdle in establishing a SNT is finding the right trustee. A trustee must be knowledgeable in SNTs and must understand the tax and Medicaid impact of distributions. Professional advisors such as trust companies, corporate trustees, attorneys, and accountants are often sought out to serve that role. However, hiring these professional advisors may not be cost effective when the trust's assets are not substantial. For those situations, a pooled SNT may make more sense.

Pooled SNTs are established and administered by nonprofit organizations to provide professional trusteeship, monitoring, and advocacy at lower costs. Separate accounts for each beneficiary are maintained but the trusts' assets are pooled together for investment purposes. Delaware CarePlan, Inc. is an example of our state's local pooled trust organization.

In addition to the SNT, another planning tool that can benefit a special needs person is an ABLE account established under The Achieving a Better Life Experience Act (ABLE). ABLE accounts are much newer than SNTs as they became law in 2014 and are gaining more traction. These accounts may be established for individuals who become disabled or blind before age 26. Only one account is allowed per beneficiary.

Contributions to ABLE accounts are not deductible for federal income tax purposes, but certain states may allow a deduction. Beginning in 2022, Delaware allows a deduction for up to $5,000 of contributions. In general, contributions are limited to the annual gift exclusion each year but additional contributions beyond the annual exclusion may be allowed for beneficiaries who are employed and not enrolled in a retirement plan with their employer.

Even though you cannot receive a federal income tax deduction for contributions to ABLE accounts, an individual can potentially receive a "savers credit" on their income tax return up to the lesser of 50% of the contribution or $2,000 ($4,000 for joint filings).

Like a 529 savings plan, earnings inside an ABLE account accumulate on a tax-free basis. Distributions are tax free if they are used for qualified disability expenses. Qualified disability expenses are expenses that relate to the designated beneficiary's disability and help maintain or improve the health, independence, or quality of life of the disabled person. The regulations provide an extensive list of eligible uses of distributions. The uses range from education and housing expenses to legal fees and funeral expenses. This list is not all-inclusive. Distributions not used for qualified expenses are subject to a 10% penalty and potentially income taxes. Like SNTs, distributions from ABLE accounts for housing expenses may reduce the SSI benefit. An ABLE account could impact an individual's SSI eligibility further. Any excess above $100,000 will count toward the resource limit described earlier.

SNTs and ABLE accounts are essential to protecting a person with disabilities from the loss of government benefits. As trusted financial professionals, we should be aware of the basic available planning tools and resources available for our clients along with the tax impact.

Michael Kelly has over ten years of experience focusing on taxes while working with various types of industries including medical practices, optometrists, law firms, franchises, family-owned businesses, and construction. Michael specializes in individual and business taxation, trust and estate taxation, state and local taxation, and nonprofit advisory. He frequently assists clients with their accounting questions and has a strong understanding of QuickBooks and other bookkeeping software. Continuously thinking of creative solutions that minimize taxes for his clients and increase client's efficiency are two of the many areas where Michael excels. He also enjoys the challenge of researching uncertain or unusual federal and state income tax issues.

Karly Laughlin began her career with the firm as an intern while completing her degree at the University of Delaware and has been with the firm ever since. Karly is a member of the firm's Estate & Trust Section where she specializes in the preparation of tax returns associated with estates, trusts, and gifts. Karly also works with a variety of clients providing tax planning, tax preparation, accounting services, and QuickBooks maintenance. In addition, she is integral in the preparation of tax returns related to nonprofit organizations. To stay abreast of important tax law and industry changes, Karly regularly attends the annual Heckerling Institute on Estate Planning conference, the Estate Planning Council of Delaware monthly meetings and Wilmington Tax Group meetings. Karly shares her knowledge by contributing to the firm's tax and small business blog – A Matter of Tax and has presented on estate, trust, and tax issues at various local organizations.

Have No Fear, the Access Is Here!

A Guide to Potential Future Trust Access for Grantors

by
Robert V.A. Harra III
and
David T. White

Gordon, Fournaris & Mammarella, P.A.

Spousal lifetime access trust ("SLAT") planning continues to be an area of interest for individuals looking to take advantage of their exemptions for federal estate tax, gift tax and generation-skipping transfer (GST) tax purposes, while benefiting a spouse. There has been recent increased discussions surrounding what some are referring to as a "back end SLAT", which is simply a SLAT where the beneficiary spouse has a power to appoint assets in further trust, at death, for the benefit of the grantor spouse (also referred to as the "contributing spouse"). Much of the recent discussions stemmed from the announcement that Florida has become the 11th state to enact legislation affording creditor protection with respect to assets held in a SLAT in the event a contributing spouse subsequently becomes a beneficiary of the SLAT upon the death of the initial beneficiary spouse.[1] While this certainly makes SLAT planning more attractive for Florida residents, Florida law does not permit the creation of self-settled asset protection trusts ("APTs"), which could create planning concerns and uncertainty for Florida grantors exploring a back end SLAT. Further, the new Florida law only addresses the situation where the contributing spouse becomes a beneficiary after the death of the initial beneficiary spouse, who remained a beneficiary for such initial beneficiary spouse's lifetime.

While these concerns are present in Florida, and other jurisdictions with similar SLAT legislation and no APT legislation, grantors can feel at ease in Delaware, where SLAT planning has been and still remains a valid tool to provide flexibility to grant a contributing spouse future beneficial access to the trust.[2]

Advantages of Spousal Lifetime Access Trusts

A SLAT is an irrevocable trust whereby a contributing spouse makes a completed gift, in trust, for the benefit of a beneficiary spouse and, if desired, the contributing spouse's descendants or other beneficiaries. The effect of the gift is that the assets, and the future appreciation of the assets, are removed from the combined estate of the spouses. Each spouse is allowed to create a SLAT for the benefit of the other spouse, meaning that, with the current estate tax, gift tax and GST tax exemptions of $12.06 million per person,[3] spouses can collectively shield $24.12 million of assets contributed in trust from future transfer taxes, while maintaining potential beneficial access through the beneficiary spouse.[4] The historically high current exemption amounts are set to sunset at the end of 2025 and return to levels in effect prior to the Tax Cuts and Jobs Act of 2017, indexed for inflation. Accordingly, SLAT planning has been particularly popular for spouses looking to take advantage of the current available exemptions without losing complete access to the assets.

In addition to the gift and estate tax benefits, the assets of a SLAT can also be sheltered from creditors of each spouse so long as certain aspects of the SLAT are maintained. Under the statutory structure, the creditors of the contributing spouse do not have access to the assets of the SLAT because the contributing spouse is not a beneficiary of the trust. Title 12, Section 3536 of the Delaware Code, addresses creditor protection for trust beneficiaries in general, which would include creditor protection for the beneficiary spouse.

Section 3536 also addresses situations where the contributing spouse becomes a beneficiary of a trust upon the death of another and further clarifies that a grantor will be treated as a beneficiary of a trust, and not as a grantor of the trust, if the grantor becomes a beneficiary pursuant to the exercise of testamentary power of appointment by another person and, upon such appointment, the creditors of the grantor may not satisfy creditor claims from the grantor's appointed interest.[5]

Florida's new statute closely resembles Delaware's statute in that it addresses creditor protection for a contributing spouse who subsequently becomes a beneficiary of a SLAT upon the death of the beneficiary spouse; however, unlike Delaware, creditor protection, and potential access generally, is limited in jurisdictions adopting similar laws to Florida to situations where the contributing spouse survives the beneficiary spouse and the beneficiary spouse remained a beneficiary until the beneficiary spouse's death.[6] In these other jurisdictions, the contributing spouse is unable to gain access prior to the death of the beneficiary spouse, even in the event of divorce.

Because of the Delaware Qualified Dispositions in Trust Act, 12 Del. C. § 3570, et seq. (the "Act"), grantors do not need to wait until the death of the beneficiary spouse to gain access to a Delaware SLAT, nor does the initial beneficiary spouse have to remain a beneficiary for such spouse's lifetime. The contributing spouse can be a direct beneficiary of a SLAT at any time due to the creditor protections offered under the Act.

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Accordingly, Delaware SLATs can be structured to provide a great amount of flexibility if potential future trust access is desired for a grantor. There are several methods that are commonly implemented to trigger future grantor access in a Delaware SLAT.

Beneficiary Spouse Holds a Limited Power of Appointment

The most common method used to provide the contributing spouse future access to a SLAT is to grant the beneficiary spouse a testamentary limited power of appointment ("LPOA") by which the beneficiary spouse can appoint the assets of the SLAT to a class of beneficiaries broad enough to include the contributing spouse upon the death of the beneficiary spouse. The class of appointees can be broad and include anyone other than the beneficiary spouse, his or her creditors, his or her estate, or the creditors of his or her estate. It could also be more restrictive and consist of the descendants of the parents of the contributing spouse.

While this method is common, there are also potential concerns that may arise if future access is desired. First, the beneficiary spouse must ensure the LPOA is properly exercised so that it will become effective at death. If the LPOA is not exercised properly, the contributing spouse will not gain access. Similarly, in the event the LPOA is exercised, it is possible that the beneficiary spouse subsequently revokes the exercise with or without the contributing spouse's knowledge, which can be particularly troublesome in the event of a divorce.

Under this method, Title 12, Section 3536 of the Delaware Code, will apply to provide creditor protection in the event the LPOA is exercised and the contributing spouse becomes a beneficiary of the SLAT as a result.

Authority to add to the Class of Beneficiaries

Another common method that may be employed to provide potential future trust access is to provide a powerholder, such as a Trust Protector, the ability to add to the class of beneficiaries during the contributing spouse's lifetime, including prior to the death of the beneficiary spouse. The potential class of beneficiaries can be limited in scope or could be broad to include anyone other than the Trust Protector, the Trust Protector's creditors, the Trust Protector's estate, or the creditors of the Trust Protector's estate. The powerholder could exercise such power to add the contributing spouse as a beneficiary of the SLAT; however, the power should only be exercised in a non-fiduciary capacity. Moreover, the powerholder should be someone other than the contributing spouse, any beneficiary of the SLAT, or any party related or subordinate to the contributing spouse or any beneficiary of the SLAT under Section 672(c) of the Internal Revenue Code of 1986, as amended.

Title 12, Section 3536(c)(1) of the Delaware Code, provides creditor protection where an individual transfers assets to an irrevocable trust and the trust includes a provision that would allow the grantor to be named as an additional beneficiary. Additionally, the Act provides creditor protection where an individual transfers assets to an irrevocable trust, retains a beneficial interest in the trust (or the ability to be added as a beneficiary of the trust) and, in certain situations, prevents creditors of the individual from reaching the assets of the trust. Accordingly, when providing a powerholder with the power to add the contributing spouse as a beneficiary of a SLAT, it is important to ensure that the SLAT conforms with the requirements of the Act so that if and/or when the contributing spouse is added as a beneficiary of the trust, there is ongoing protection from creditor claims against the trust. Under the Act, if a creditor has a claim which arose before the transfer of assets to the trust, the creditor must bring suit within 4 years after the transfer of assets to the trust or, if later, within 1 year after the creditor discovered (or should have discovered) the trust and must prove by clear and convincing evidence that the creation and funding of the trust was a fraudulent transfer.[7]

Utilizing this method will allow the powerholder to add the contributing spouse as a beneficiary of the trust at any time, including during the lifetime of the beneficiary spouse, upon the death of the beneficiary spouse or at the time of the divorce, allowing the contributing spouse to maintain access to the assets in the trust.

Option for Non-Grantor Trust Status

Typically, a SLAT is created and taxed as a grantor trust, meaning that the contributing spouse would be responsible for the tax liability of the trust. It is possible, however, to structure a SLAT as a non-grantor trust (often referred to as a "SLANT"), meaning that the trust would pay its on tax liability for any income and capital gain accumulated in trust. This is primarily accomplished by requiring the consent of adverse parties, within the meaning of Section 672(a) of the Internal Revenue Code, with respect to certain decisions, such as distribution decisions to the beneficiary spouse.

Conclusion

SLAT planning remains a great estate planning tool for married couples for a number of reasons, including estate and gift tax advantages and creditor protection. For grantors who are interested in irrevocable trust planning, but may have reservations due to concerns regarding complete loss of beneficial access of the assets contributed to a trust, Delaware law offers many advantages and options that can alleviate many typical concerns. The Act, coupled with the protections provided under Title 12, Section 3536 of the Delaware Code, and Delaware's directed trust laws, continue to make Delaware one of the premiere locations to establish a SLAT.

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Notes:
1- Fla. Stat. § 736.0505(3).
2- See 12 Del. C. § 3536 and 12 Del. C. § 3570, et seq.
3- 26 U.S.C. § 2503(b).
4- It is important to note that SLATs must be carefully structured to avoid triggering the reciprocal trust doctrine if both spouses are creating one for the benefit of the other.
5- 12 Del. C. § 3536(c).
6- See Fla. Stat. § 736.0505(3).
7- 12 Del. C. § 3572(b).

Keeping Secrets Can Be Risky Business

by
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We all know that, as a general rule, beneficiaries must be kept informed by trustees. Under Delaware law, beneficiaries are, at a minimum, entitled to know "the existence of the trust, their status as beneficiaries . . . any significant changes in their beneficiary status; and . . . material information needed to protect their interests."[1] Further, trustees must disclose additional trust information upon the reasonable request of a beneficiary.[2]

At times, this duty to keep beneficiaries informed interferes with the grantor's intentions, many of whom are concerned that knowledge of the trust will detrimentally impact the beneficiary. Will this guaranteed source of wealth discourage young beneficiaries from working hard? Will it encourage a beneficiary to take imprudent financial risks knowing that there is a safety net? Will it lead to the beneficiary living an unproductive and unfulfilling life? These concerns have steered many grantors away from trust planning, notwithstanding the tax benefits that could otherwise be achieved.

Delaware silent trusts offer a clear solution to these concerns. Under Delaware law, grantors may include terms in the trust agreement that modify the trustee's traditional duty to inform beneficiaries about their interest in a trust. Pursuant to 12 Del. C. § 3303(c), the terms of a governing instrument may "expand, restrict, eliminate, or otherwise vary" the beneficiary's right to be informed. The ability to alter the beneficiary's right to be informed, however, is not without limitation; a grantor can only keep a beneficiary uninformed "for a period of time."[3] That period of time can relate to a date certain, the attainment of a specified age of the beneficiary, the death of a specified individual, or the occurrence of a specified event.[4]

Silent trusts (often called quiet trusts) come in a variety of forms. Some prohibit a beneficiary from receiving any information whatsoever about the trust (including the trust's existence), while others limit the amount and timing of information to be disclosed. However structured, silent trusts have proven quite appealing to many grantors. And while the efficacy of silent trusts can be debated,[5] the ability to keep some or all trust information from a beneficiary is often a major, if not the primary, reason why a grantor chooses to settle a trust in Delaware.

Although silent trusts have become fairly commonplace over the past two decades, administering them still presents many challenges for trustees. When considering serving as the trustee of a silent trust, trustees must carefully review the trust agreement to ensure that it (1) contains language clearly outlining the trustee's duties, obligations, and liabilities regarding the dissemination of trust information to the beneficiaries; (2) provides for the appointment of a designated representative to represent the interests of the prohibited beneficiaries; (3) does not contain provisions that are incompatible with the silent trust provisions; and (4) limits the trustee's liability for inadvertent disclosure of information.

How "Silent" is the Trust?

Prior to accepting an appointment as trustee of a silent trust, the trustee must carefully review the silent trust provisions to ensure they comply with 12 Del. C. § 3303. Remember that, under the common law, a trustee has a duty to provide trust information to a beneficiary. Therefore, careful drafting is required to make certain the trustee is not subject to those common law duties. In addition, the use of clear language should help to limit the trustee's liability for not providing the beneficiaries with trust information.

To start, the trust agreement should clearly specify the trustee's duties with respect to informing a beneficiary about his or her interest in the trust. Silent trust language should expressly prohibit the trustee from making disclosures. For example, if the grantor wishes to exclude all information, including the existence of the trust, from the beneficiary, the silent trust provisions should state that the trustee "shall not" provide such information for the intended period of time. Further, if the grantor wishes for some, but not all, information to be withheld from a beneficiary, the silent trust provisions should clearly delineate exactly which documentation or information must be withheld. With all silent trusts, the trust agreement should expressly exculpate the trustee from liability for its compliance with the silent trust provisions, and provide that the trustee will be deemed to have complied with its fiduciary duties by supplying the trust information to the beneficiary's designated representative (as explained in more detail below).[6]

Trustees must be cautious with discretionary silent trust provisions. Language providing that the trustee "has no obligation" to keep beneficiaries informed, or that the trustee "may, in its discretion" decide what information to provide to a beneficiary places the discretion (and the legal burden) on the trustee. Consequently, trustees will be subject to greater scrutiny when withholding information from trust beneficiaries.[7] With this language, the trustee will inevitably be put in the uncomfortable position of determining which trust information is material, which beneficiaries should be informed, and what trust information the grantor intended the beneficiaries to receive. This can also lead to disagreements with the grantor, who may not understand the discretionary nature of the language used.

Careful review of silent trust provisions is especially critical when migrating trusts from other states to Delaware. While many jurisdictions have adopted silent trust statutes, they are not all uniform. A trust agreement prepared pursuant to another jurisdiction's silent trust statute may not produce the same results in Delaware. Therefore, before administering the trust as "silent," trustees must review the trust provisions to ensure they comply with Delaware's silent trust statute.

Initial communication is key when accepting a silent trust. To avoid future disagreements (and possible removal or liability), the trustee should be candid with the client regarding how it intends to administer the silent trust provisions and its practice of sending statements and other trust information to beneficiaries. Undoubtedly, an

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unsuspecting grantor will be quite displeased to learn that her children are suddenly going to receive information about a trust that was previously administered as a completely silent trust by a different trustee in another jurisdiction. These surprises can be avoided by clear communication.

Is there a Designated Representative?

If the beneficiary is not informed of his or her interests in the trust, several problems arise for the trustee. How will the trustee be aware of the beneficiary's needs? How can the beneficiary consent to trustee conduct? When will the statute of limitations begin to run for the trustee's acts? How can the beneficiary enter into a nonjudicial settlement agreement? The appointment of a designated representative helps to resolve these issues, and is critical to the administration of a silent trust.

A designated representative is the individual appointed to represent a trust beneficiary's interests and serves as the link between the trustee and the beneficiary. The person serving as a designated representative should be intimately aware of the beneficiary's circumstances, and must keep apprised of the trust activities as if the designated representative were the beneficiary.

The powers and duties of the designated representative should be clearly outlined in the trust agreement. These provisions should provide that the designated representative will receive all notices on behalf of the beneficiary. In addition, the trust provisions should state that the designated representative will bind the beneficiary in judicial proceedings and in nonjudicial matters, such as nonjudicial settlement agreements, release agreements, and reporting for purposes of measuring any applicable limitations periods.[8]

Because the designated representative plays such an important role in the administration of a silent trust, the trust agreement must provide a mechanism for the appointment of a successor designated representative in the event of a vacancy. Relationships with friends, professionals, and even family members will change over time, and an appropriate designated representative today may not be an appropriate designated representative in the future.

It should also be determined whether the designated representative will serve in a fiduciary capacity. Under Delaware law, the designated representative is presumed to serve in a fiduciary capacity unless the trust provisions provide otherwise.[9] Preferably, the designated representative will be a fiduciary, and be held to fiduciary standards.[10] Without question, having a designated representative serving in a fiduciary capacity is more protective to both the beneficiary and the trustee. However, because fiduciaries are subject to higher standards, some individuals may only be willing to serve in a nonfiduciary capacity.

Are the Provisions Consistent with the Entire Trust Agreement?

Too often, silent trust provisions are inserted into trust agreements without substantial forethought. As such, a provision restricting a beneficiary's right to trust information might conflict with other provisions of the trust agreement or interfere with the trustee's ability to properly administer the trust. Conflicts with other provisions could have meaningful consequences. For example, if the silent trust provisions are not carefully crafted, a beneficiary's Crummey withdrawal right may be ineffective, precluding the use of the grantor's annual exclusion for future gifts to the trust. Dispositive trust provisions should also be closely reviewed. Mandatory distributions or withdrawal rights at certain ages will obviously require the disclosure of the trust. Likewise, a silent beneficiary may end up receiving a K-1 for a distribution made directly for his or her benefit. The silent trust provisions should align with these dispositive provisions so the trustee can effectively administer the trust.

Are you Liable for Accidental Disclosures?

Inadvertent disclosures to beneficiaries can and will happen. A system error could result in account statements being sent to silent beneficiaries, or perhaps a new trust officer could misinterpret the silent trust provisions and mistakenly disclose the trust. More often, an older family member will tip off a younger beneficiary regarding the existence of the trust. Whatever the case may be, it's important to have a plan in place for addressing these unintended disclosures. Undoubtedly, the beneficiary will have questions and will want to know more about the trust. Communication with the grantor, the designated representative, and others involved with the trust will be crucial to addressing these disclosures and producing the best response to the silent trust beneficiary. Additionally, the trust agreement should address the fact that inadvertent disclosures will occur, and contain provisions absolving the trustee from liability for mistaken, unintentional, and inadvertent disclosures that may be caused by the trustee or a third party.

Conclusion

The widespread use of silent trusts over the past two decades suggests that they are here to stay. Trustees, however, will continue to face challenges with the administration of silent trusts. Nevertheless, trustees should not shy away from these challenging trusts, but they should meticulously review all new opportunities that restrict information to beneficiaries to ensure that they do not find themselves in hot water with the grantor, the beneficiaries, or the court.

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NOTES

1- *Tigani v. Tigani*, 2021 WL 1197576, at *15 (Del. Ch. Mar. 30, 2021) quoting *Deputy v. Deputy*, 2020 WL 1018554, at *40 (Del. Ch. Mar. 2, 2020).
2- *McNeil v. McNeil*, 798 A.2d. 503, 510 (Del. 2002); *See also* Restatement (Third) of Trusts, § 82(2).
3- 12 *Del. C.* § 3303(c).
4- 12 *Del. C.* § 3303(c).
5- *See, e.g.*, David A. Diamond, *Considering Quiet Trusts in the Larger Picture of Family Governance*, TRUSTS & ESTATES, May 2022, at 36.
6- *Mennen v. Wilmington Trust Company,* 2015 WL 1914599, at *22 (Del. Ch. Apr. 24, 2015) ("When [] a grant of powers is combined with an exculpatory provision, a trustee is effectively insulated from liability . . . provided the exculpatory provision in question is enforceable and the trustee's conduct fell within it.").
7- 12 *Del. C.* § 3315(a).
8- 12 *Del. C.* § 3303(d).
9- 12 *Del. C.* § 3339(d).
10- In certain circumstances the designated representative is deemed to act as a fiduciary, notwithstanding the terms of the governing instrument. *See* 12 *Del. C.* § 3339(a)(4)a.

Meaningful CRA Reform at Last

Alice Judd, CRCM
Managing Principal
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"Banks should plan on additional support for their CRA program and should start analyzing how they might fare against the new metrics and available information."

On May 5, 2022, the Federal Deposit Insurance Corporation, The Office of the Comptroller of the Currency and the Federal Reserve Board issued a joint Notice of Proposed Rulemaking on the Community Reinvestment Act with comments due by August 5, 2022. The nearly 700-page NPR is intended to strengthen and modernize the rule that implements the CRA. The last significant interagency revision to the CRA regulations occurred in 1995.

The proposed rule brings about significant changes to the way CRA performance would be evaluated in the future. While the proposed changes increase transparency and clarity around requirements, they pose challenges, particularly for large banks – those with assets greater than $2 billion. One of the most significant changes for large banks is the requirement to create retail lending assessment areas beyond branch(facility)-based AA, where the bank has originated at least 100 home mortgage or 250 small business loans in any Metropolitan Statistical Area (MSA) or the combined non-MSA in a state for 2 consecutive years.

Another notable change is the new Retail Lending Test that would evaluate large and intermediate banks against specific market-based benchmarks for lending to low- to moderate-income (LMI) borrowers and geographies. Intermediate banks would be those with assets of $600 million to $2 billion. The evaluation would compare a bank's retail lending loan to deposit ratio in its facility-based AA to other banks in that area. Banks that meet or exceed a metric of 30% of the market ratio would also have their major product lines assessed based on borrower and geographic distribution metrics in each AA and outside of their AA. Major product lines are those that are 15% or more-dollar volume of closed- and open-end home mortgages, multifamily loans, small business loans, small farm loans, and auto loans in an assessment area. This test provides more transparency to evaluations, but failure to meet the 30% metric would rate as "Substantial Compliance" or "Needs to Improve," depending on factors and bases for not meeting the threshold. To compare your bank to the metrics considered in the proposal, the Federal Reserve has a search tool for HMDA, small business, and small farm loan products, based on historical loan data over the 2017–2019 timeframe and demographic/geographic definitions from 2019 data. Users may select a County, MSA, or a Metropolitan Division, and view the Geographic and Borrower performance thresholds for each of the listed products.

In addition to the lending tests, the new Retail Products and Services Test and the Community Development (CD) Financing Test would only apply to large banks and a new CD Financing Metric would measure the dollar amount of a bank's CD loans and investments to its capacity. Benchmarks would be established using local area context and the evaluation would include a qualitative impact review. Like the current test, under the Retail Services and Products Test, banks would be evaluated on how well their credit and deposit products meet LMI community needs of affordability and responsiveness in facility-based assessment areas, state, multistate MSAs, and overall institution levels. Banks with more than $10 billion in assets would also be evaluated for their remote service facility availability, digital, and other delivery systems and the meet responsiveness of their product and service offerings to LMI communities. They would also be required to collect, maintain, and report additional data, including hours of CD service activity.

On a positive note, small banks would continue to be evaluated as they are today, however, with higher asset thresholds enabling more community banks to fall into that category. Another positive is the new CD Financing test that includes both loans and investments and enables banks to consider those outside of facility-based assessments areas. There is also flexibility in how banks may be evaluated. For example, small banks may opt into the Retail Lending Test, and intermediate banks may opt into the CD Financing test.

Banks should plan on additional support for their CRA program and should start analyzing how they might fare against the new metrics and available information. Changes to a bank's current CRA performance strategy may be required to achieve a satisfactory rating given the new thresholds, new tests, and metrics.

One final observation. The proposed 12-month implementation period is aggressive considering the likely dual implementation of the new CRA rule and the CFPB's expected final rule for small business lending data collection (Section 1071 of the Dodd-Frank Act). Bank staff charged with system upgrades, including dependency on third-party vendors, and processes for data collection and reporting may consider 12 months an impractical goal. Then too, banks that initiate system and compliance changes prior to finalization of the rule run the risk of having to backtrack if the final rule is different from the current proposal. These concerns and others were expressed in a Statement for the Record of the American Bankers Association Before the Subcommittee on Consumer Protection and Financial Institutions of the U.S. House Financial Services Committee, July 13, 2022.

Accounting for Success

Tax Repercussions of Retirement Accounts Owning Partnerships

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"A retirement account is exempt from all income taxes except for taxes imposed on unrelated business taxable income."

Investors are likely already aware that the basic purpose of a retirement account is to defer taxes and allow investments to compound tax-free until it is time for distributions to be made. However, investors must be careful with some of their investment choices as the wrong one could cause unintended results.

Investors may be familiar with publicly traded partnerships as they will receive a Schedule K-1 each tax season if they are invested in one. These K-1s follow the "flow-through" concept which requires the owners of the partnership to report their allocable share of income on their own tax return. Though the flow-through concept is well-known among tax practitioners, it can cause big problems in situations where a retirement account has an interest in a partnership.

A retirement account is exempt from all income taxes except for taxes imposed on unrelated business taxable income (UBTI). UBTI is income from activities that are not substantially related to the functions for which the IRA is allowed an exemption from income tax, such as regularly engaging in a business normally carried on for profit. Tax resulting from unrelated business income is known as UBIT.

Section 512(c)(1) requires a retirement plan which owns an interest in a partnership to include its share of the gross income of a partnership when computing UBIT.

The below rulings capture a few examples into the train of thought of the IRS and certainly make it clear that partnerships owned by your retirement account are at risk when it comes to UBIT.

> In Revenue Ruling 79-222, the IRS examines a situation where an IRA owns an interest in a partnership as a limited partner and the IRA does not participate in management. The partnership regularly carries on a business activity. The IRS ruled the income received by the partnership may result in UBIT.

> In Private Letter Ruling 9703026, an IRA owned a 3.32% interest as a limited partner in a non-publicly traded partnership. The IRA received income from the regular operations of the business and received income from the partnership's rental of a warehouse. The IRS ruled that the income from the regular business operations was subject to UBIT. Even though there are exceptions to rental income being subject to UBIT, the rental income in this example was generated by property that is encumbered by debt. Debt-financed income is also subject to UBIT.

Due to the flow-through nature of publicly traded partnerships which allocate business income to IRAs through a K-1, the mere ownership of the partnership is a problem even when the partnership does not distribute any cash to the IRA. When an IRA is subject to UBIT, it will require an annual tax filing on Form 990-T assuming the UBTI exceeds $1,000. Since an IRA is considered a trust for federal income tax purposes, any tax generated on Form 990-T will be taxed at the highly compressed rates associated with trusts.

An investment may produce losses that are considered "unrelated". A tax practitioner may find it useful to file Form 990-T to report those losses in case a future event generates UBTI since the losses can be "carried over" and used against future income.

A common saying in our business is "don't let the tax tail wag the dog". For example, we must plan smartly and minimize taxes where we can, but the goal is to always put yourself in a better financial position even if it means paying some tax. However, when it comes to retirement plans owning partnerships, we should certainly make it a priority to focus on the tax impact first before any consideration for the investment results. When a partnership is part of an IRA portfolio, it could ruin the purpose of an IRA which is to defer taxes.


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Executive Benefits

Louis D. Memmolo, AIF, GBA, NQPA
Weiner Benefits Group, LLC

"Executive benefits are designed to provide your top employees with a higher level of benefits and compensation."

If you take a moment to consider the success of your organization. How much of that success is due to the hard work and commitment of your key employees and executives?

Recruiting and retaining top talent all the way through retirement is a major priority for most businesses, especially key employees, and members of the executive staff. Executive benefits are designed to provide your top employees with a higher level of benefits and compensation, especially since qualified retirement plans like 401(k)'s restrict the amount of money an individual can contribute on a tax-favored basis making it more difficult to accumulate enough for retirement.

Executive benefits should be part of a well-designed thoughtfully executed strategy creating a holistic compensation plan that provides tax advantages for both employers and employees. These plans should help you recruit top talent, reward performance and encourage loyalty.

Here are some of the more common executive benefits that you may wish to offer at your organization.

Non-qualified Deferred Compensation Plans

- Executives can defer some of their compensation, either salary or bonuses, until retirement.
- Employers can offer Supplemental Executive Retirement Plans (SERPs), in which additional funding is provided for a defined benefit or defined contribution plan for top executives. No taxes are due on the money placed in these plans until it is received by the executives.
- 401(k) mirror plans that carve out the "top hat" group on qualified plans deemed top heavy.
- Plans pay an executive's spouse in the event of an executive's death before retirement.
- Plans pay out in the event of disability.
- These plans can be incorporated into an employer's current qualified plan.
- Plans avoid IRS requirements for qualified plans and require minimal ERISA compliance.

NQDC plans can be informally funded with life insurance policies for tax advantaged accumulation and aid in the cost recovery through the income tax-free death benefit.

Executive Bonus Plans (Also Known as Section 162 Plans)

- Employees purchase a permanent life insurance policy and then employers provide the premium as a bonus. This is considered taxable income and is tax-deductible for employers.
- Employees control the policy (including death benefits and cash value) and can take loans or withdrawals on the policy as they see fit.
- In the event of an executive's death, his or her family receives the death benefit.

Split Dollar Plans

- Executives have the ability to purchase life insurance coverage without paying the premiums, payment responsibility rests on employers. Employers receive back the amount of the premiums when the executive dies.

Supplemental Disability Income Insurance

- A typical group long-term disability policy provides 60% of an employee's income, up to the allotted maximum amount. For executives, the maximum benefit may not reach 50% of their salary, which would not fare well for them in the event of disability.
- Employers can purchase individual supplemental disability income insurance to bring the executive's total benefit up to the same level as other employees.

At their core, key executive benefits that include NQDC plans are a custom designed contractual arrangement between an employer and a select group of eligible plan participants that achieves the goals and objectives of all parties to the agreement. It's imperative to engage a team of qualified professionals that include a nonqualified plan advisor to design and implement an effective plan.

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SOFR Won, So Why Does the Complicated Transition Language Persist?

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"Given that the long LIBOR transition ordeal is now in our wake, and banks are so keen on 30 day Term SOFR, why does this language persist?"

Now that banks and other commercial real estate lenders have weaned themselves from LIBOR rates due to the edicts of regulators, most lenders now originate new variable rate mortgage loans using the 30 day Term Secured Overnight Financing Rate (SOFR) published by the CME Group (an American global markets company that is the world's largest financial derivatives exchange). Fundamental differences between LIBOR and SOFR include that LIBOR is unsecured and SOFR is secured by treasuries; LIBOR has various forwarding-looking term length quotes while SOFR is based on an overnight rate calculated in arrears; and unlike SOFR LIBOR has a bank credit risk premium because it is based on interbank loans. By now many of you may have received exhaustive training regarding the new SOFR rate, and have seen the multiple paragraphs of rate transition language in the new note forms that use SOFR. A bank's need for interest rate change/transition language in notes if the stated rate is no longer available or reliable became painfully clear over the last few years, especially after March 2021 when the U.K. Financial Conduct Authority announced that LIBOR settings would no longer be calculated after June 30, 2023. However, given that the long LIBOR transition ordeal is now in our wake, and banks are so keen on 30 day Term SOFR, why does this language persist?

The primary reason is that if the interest rate market changes, lenders want to keep open the possibility of converting their loans from 30 day Term SOFR to the competing "Fed Rate" variable rate, which is a compound average of SOFR on a rolling 30-day period calculated in advance. The Fed Rate is currently being used by FannieMae and FreddieMac for new loans. There is some pressure in the market to follow FannieMae and FreddieMac from investors in securitized bonds, which also use the Fed Rate.

There is a clause that sometimes appears in the interest rate transition language in new SOFR notes that bankers need to be careful about, regarding "Adjusted Term SOFR." This defined term was appropriate for loans that had the LIBOR interest rate, since it means that when LIBOR rates for existing loans transition to SOFR the interest rate spread will increase by 0.11448%. This increase is to account for the typical difference between a LIBOR rate and SOFR Rate, which was calculated by the Federal Reserve Board's Alternative Reference Rates Committee. If this language from LIBOR transition clauses is copied into SOFR transition clauses, it will result in effectively having two spreads added to the floating SOFR rate: the spread stated in the note, plus the 0.11448%. Thus, the Adjusted Term SOFR clause must be stricken in new notes, and bankers should stay current on updated bank policies for loan document language as the interest rate environment continues to evolve.

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