Straying from Home —
The Search for Situs

BY MICHAEL MALAKOFF, MANAGING DIRECTOR, WEALTH IMPACT PLANNING
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Trusts can play a significant role in family wealth management. When establishing a trust, or when considering moving a trust, there are important considerations about which state jurisdiction may be the most favorable to the family’s long-term mission and vision for their wealth. Since different states offer different opportunities, one should carefully assess these differences before selecting a “situs” for a trust. And, while the word “trust” covers a wide range of fiduciary relationships, when used in this paper, the word “trust” refers only to irrevocable trusts.

Before beginning the analysis, perhaps a primer is in order. First of all, what is situs? Situs is the place you choose as your trust’s “home” or its state of “incorporation.” The question of trust situs is much like the choice a professional athlete or retiree faces when deciding where to make her new home, or where a business owner decides to incorporate. The athlete or retiree may choose Florida in lieu of California or New York, because Florida does not have a state income tax. A business owner may choose to incorporate in Nevada or Delaware versus a state with less favorable business or tax laws.

When it comes to the ideal jurisdiction within which to set up and administer your trust, and whose laws will control it (i.e., govern the trust, the trustee and the interpretation of the trust document itself), it may pay to look outside of your home state. In fact, straying from home may be the best choice for realizing the mission and vision you have for your wealth.

There are three frequently addressed reasons to shop for a trust situs: taxes, taxes and taxes. The ability to delay, defer and possibly avoid generation-skipping transfer (GST), estate and state income taxes provides the opportunity for tremendous growth of the assets of a trust. Yet, situs analysis should not be limited to taxes alone. There are other important state law considerations when selecting a situs, including creditor protection, the ability to create a self-settled (or asset protection) trust, and privacy. While many states have created a trust environment that is favorable to long-term planning, taking all of the factors listed above into account (taxes and other state law considerations), two states frequently are named as the top preferred domestic trust jurisdictions: Delaware and South Dakota.

Ultimately, the “best” jurisdiction for your trust depends upon your own unique goals, facts and circumstances, and should be explored with legal counsel (including an attorney licensed in the state being considered as the situs of your trust).
SITU Todd GEN ERAL
The determination about sius is not necessarily black and white. Where a trust is currently siused can be a difficult question to answer, and the answer may be different for both taxes and trust administration. The question of which state’s laws apply is, of course, a question of state law, and a number of factors come into play in the analysis:

- The terms of the document (i.e. does it specify which state’s laws govern the administration of the trust or the interpretation of the document itself);
- The state of residence of the grantor/trustor when the document was signed (or at her death);
- The type of trust (intervivos or testamentary);
- The type of assets contributed to or held by the trust;
- The state of residence of the trustee;
- The state where the trust’s assets are physically located; and
- The state of residence of the trust’s beneficiaries.

This list is by no means all inclusive and is used only to illustrate the complexities in determining a trust’s situs and the importance of utilizing competent and local counsel when setting up any trust.

THE CASE FOR TRUSTS AND DYNASTY TRUSTS IN PARTICULAR
Transfers in trust as opposed to outright gifts are frequently used to balance the needs of current and future stakeholders (i.e., beneficiaries). They also may be used to protect gift or inheritance recipients from themselves, be it in response to a history of substance abuse or in order to prevent other potentially self-destructive behaviors, including simply overspending. Gifts in trust may also be structured to protect the gift or legacy from falling into the hands of unintended persons, including the recipient’s creditors or a divorcing spouse. There are investment related reasons to make transfers in trusts as well, such as: centralizing asset management, consolidating voting rights, or placing restrictions on the sale, transfer or encumbrance of property.

Trusts are also used as vehicles in more complex wealth transfer strategies such as grantor retained annuity trusts (GRATs) or intentionally defective irrevocable trust sale transactions (IDITs). When successful, the use of GRATs and IDITs reduce the tax cost of transferring property as compared to making gifts of property directly.

Trusts designed to last more than three generations, thousands of years, or with no definitive end are commonly referred to as perpetual or dynasty trusts. One potential and often-sought benefit of dynasty trusts is the lack of additional transfer taxes after funding the trust. For example, a married couple has the ability to transfer over $10.5MM in trust in 2013 without paying gift taxes (assuming no prior taxable gifts). Furthermore, assuming the couple were to allocate their $10.5MM in Generation-Skipping Transfer Tax exemption
amount to that gift to the trust, all funds transferred and all growth on the 2013 gift within the trust could be paid out to grandchildren, great-grandchildren or any successive generation (at any later date) free of Generation-Skipping Transfer taxes (assuming no retroactive changes are made to the current transfer tax regime).

Likewise, through the use of more sophisticated planning (such as a sale to a trust that is treated as a grantor trust for income tax purposes), the value of the $10.5MM GSTT exemption amount can be leveraged to insulate much greater amounts (up to a multiple of ten times the amount of funds in the trust using a conservative 10% seed capital estimate to support the sale). Thus, the couple’s $10.5MM exemptions (gift and Generation-Skipping Transfer amounts) may be able to shelter $105MM (plus appreciation) from future transfer taxes. Contrast this with a trust that is forced to terminate at the end of a perpetuities period where the trust funds paid out to a beneficiary would then be subject to tax in their estate or subject to gift taxes in the event of a gift. Additionally, once out of the trust, the funds would also be subject to Generation-Skipping Transfer taxes when gifted or when transferred at death. Due to the fact that when properly funded, assets can escape transfer taxes for generations, the use of a dynasty trust may also be an effective means to protect and retain a family business or other legacy asset in perpetuity.

In addition to tax and other benefits of making transfers in trust, dynasty trusts can be used to promote healthy family dynamics and positive family governance.

In their article titled “In Defense of Multi-generational Trusts,” Daniel G. Worthington and Daniel D. Mielnicki elaborate on the family dynamics and governance benefits of dynasty trusts. The authors feel that properly designed multi-generational trusts encourage connectivity between generations. They believe that through dynasty trusts, families can harness their human and intellectual capital to enable them to do “good, not just well.” They opine multi-generational trusts may also encourage successive generations to be builders and stewards of the family capital.

Dynasty trusts can be powerful tools that can be sufficiently flexible to both provide for and remain relevant to countless generations.

**KEY TO THE KINGDOM**

The key to setting up a perpetual or dynastic trust lies in the abolition or modification of the common law Rule Against Perpetuities (generally stated – a very old rule that limits how long a trust may last). The Rule Against Perpetuities can be traced back to 16th century England and stems from a common law principle designed to protect the ability to transfer property by limiting remoteness of vesting to a fixed period of time. Effectively, except in those states that have abolished the Rule Against Perpetuities, the rule restricts the ability to create a dynasty trust (i.e., one that lasts in perpetuity) because it creates a foreseeable end for the trust. It does so by voiding any trust with a vesting period in excess of a “life in being” (i.e., any beneficiary or other stakeholder alive when the trust is created) plus 21 years.
Based on these examples, it seems clear that there is a significant financial advantage to maintaining property in trust for a period in excess of the common law Rule Against Perpetuities.

Using the time period in the common law rule, the realistic life of a trust is less than 150 years. In fact, using the lifespan of Jean Calment, who lived until the ripe old age of 122 and is the longest verified living person (as indicated by Wikipedia), a grantor who selected Ms. Calment as her “life in being” would have a trust with a maximum duration of 143 years. While a trust with a duration of 143 years is nothing to sneeze at, perhaps a couple of examples are in order to demonstrate the benefits of an even-longer duration.

**Non-exempt vs. Exempt Trusts**
Assumes 3% Growth and a 40% Tax every 37.5 Years

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The examples herein are hypothetical in nature and provided for illustrative purposes only.

**Trust Subject to the Rule Against Perpetuities vs. Perpetual Trust**
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</tr>
</tbody>
</table>

The examples herein are hypothetical in nature and provided for illustrative purposes only.
Based on these examples, it seems clear that there is a significant financial advantage to maintaining property in trust for a period in excess of the common law Rule Against Perpetuities. That advantage is compounded as you subject trust property to successive perpetuities periods.

As of this writing, Alaska, Delaware, South Dakota and eight other states have abolished or repealed the common law Rule Against Perpetuities (see Selective Analysis chart at the end of this paper). Note that, in Delaware, there is still a special perpetuities period for real property at 110 years.

Additionally, a number of states have retained the Rule Against Perpetuities as a default rule, but allow a grantor to opt-out in the trust document. However, it is not clear whether the opt-out approach will be effective for GST tax purposes, because each opt-out state has retained some form of the Rule Against Perpetuities while failing to define by statute timing and vesting elements. It has been postulated that a trust set up in one of these opt-out jurisdictions could have a taxable event at the expiration of the state’s perpetuities period even if the grantor opted-out of the Rule Against Perpetuities in her trust document. Without adequate case law or Internal Revenue Service guidance to support the lack of a GST tax at the expiration of the statutory perpetuities period in an opt-out state, these jurisdictions seem to be less favorable than those states where the Rule Against Perpetuities has been abolished.

Other states that have modified their Rule Against Perpetuities to a defined number of years - some as short as 150 years or as long as 1,000 years. Even though such a fixed period may seem long enough (even inconceivably so), all things being equal, having no limit may provide more flexibility and greater financial benefits. Absent other reasons to use one of the jurisdictions with a modified period, even one as long 1,000 years, a grantor should at least consider selecting Alaska, Delaware, South Dakota, or one of the other eight states that has abolished the Rule Against Perpetuities as the situs of their trust.

One should give pause to selecting one of states that has modified its Rule Against Perpetuities, given the transfer tax and other benefits of a truly perpetual trust, and due to the fact that there may be adverse transfer tax consequences should a grantor, trustee or beneficiary choose to move a trust to a jurisdiction with a perpetuities period greater than the original home state’s period (i.e. moving a trust with a 150-year perpetuities period to South Dakota, Delaware or even Colorado - with its 1,000-year perpetuities period).

In the example mentioned above, moving from Washington (with its 150-year perpetuities period) to Colorado may be deemed a constructive addition to the trust (if Colorado’s perpetuities period were to apply after the change in situs) because the beneficiaries’ interest has materially changed – it now lasts an additional 850 years. This deemed addition to the trust could have a negative impact on the trust’s GST tax status and could cause future trust distributions (and the final distribution of trust assets when the trust terminates) to be subject to Generation-Skipping Transfer tax, even if the trust previously (i.e. before the move) was fully sheltered from GST taxes.
While there is no federal Rule Against Perpetuities, President Obama has proposed (in his fiscal year 2012, 2013 and 2014 Green Books – the general explanation of the Administration’s revenue proposals) a 90-year limit on GST tax exemptions. His proposal would cause a GST tax to be imposed on trust distributions (or terminations) after the 90th anniversary of the creation of a trust. Prior proposed limits include a Treasury Department two-generation proposal in 2005. While no legislation has been signed into law, clearly the Service and our current President recognize the tax implications of allowing trusts to continue in perpetuity.

THE THIRD TAX IN THE EQUATION

While domestic trusts cannot escape federal income taxes, two of the states that allow perpetual trusts have no state income tax (Alaska and South Dakota), while three of the perpetual states exempt non-resident grantors and non-resident beneficiaries from income tax (Delaware, New Hampshire and Wisconsin).

Imagine the multiplier to be used if a dynasty trust was not subject to annual state income taxes, in addition to being exempt from additional transfer taxes...

As previously discussed, the question of where a trust will be taxed is determined by a number of factors, and the fact that trust income is not taxed at the trust level does not mean trust income, when distributed, will escape taxation in the hands of the trust’s beneficiaries.
The protections afforded to trusts, trust property and trust beneficiaries provides further differentiation among the states and should provide perspective on our focus on Delaware and South Dakota.

Protection from creditors, be it a former spouse or a third party, can be divided into two types: spendthrift protection and discretionary trust protection.

Spendthrift protection, which is drafted into most trust documents, is aimed at preventing trust beneficiaries from transferring their interest in a trust voluntarily as well as from court ordered or involuntary transfers. Both South Dakota and Delaware have codified spendthrift protection and do not allow creditors to force a distribution. Notably, these states have carved out an exception for fulfillment of the beneficiary’s mandatory or support interests. As an additional asset protection strategy, both states allow a trustee to pay a beneficiary’s expenses directly (to keep the assets out of the beneficiary’s unprotected hands).

Discretionary trust protection stems from the English common law principal that the beneficiary of a discretionary trust (a trust without mandatory distributions) has no enforceable right to a distribution and does not hold a property interest in the trust. South Dakota and Delaware statutes both provide that trustees cannot be compelled to make distributions of discretionary interests; therefore, the beneficiary has no right to distributions, and there is nothing for a creditor to attach. There are exceptions. For example, in cases of abuse of discretion, a Delaware trustee can be compelled to make distributions, and in South Dakota, a distribution can be compelled when a trustee has acted dishonestly, with improper motive or has failed to act.

Along with Delaware and South Dakota, Nevada is frequently mentioned as one of the preferred jurisdictions when it comes to protection from creditors. However, Nevada does not allow perpetual trusts, and one commentator (Richard Nenno) has questioned whether Nevada’s rule allowing 365-year trusts is valid, considering it is contrary to a provision in Nevada’s constitution prohibiting perpetuities. Mr. Nenno further points out in LISI Asset Protection Planning Newsletter #202 (June 4, 2012), a 2002 ballot measure to repeal the constitutional prohibition failed. Without the ability to set up a truly perpetual trust in Nevada, we will not be focusing on or distinguishing that state’s creditor protection laws from those of Delaware or South Dakota.
Can’t Touch This

An irrevocable trust that you set up for your own benefit, known as a “self-settled trust” and often used for asset protection, used to be the exclusive domain of foreign jurisdictions like the Cook Islands or Guernsey. In general, the policy in the U.S. and at common law was that it is permissible to place protections on assets that you give to others, but not that you give to yourself. However, a growing number of states (12 including Alaska, Delaware, Nevada, Ohio and South Dakota) have changed their policy and have passed laws to allow self-settled trusts.

Because of their complexities, we will save discussion of the merits of asset protection trusts for a later paper. However, at a high level, one should be aware that there are exceptions to both spendthrift and discretionary trust protections with regard to self-settled trusts, meaning that the protections are not absolute. A category of creditors called “exception creditors” may be allowed to force a distribution from a domestic asset protection trust. Claimants for child support, spousal maintenance and fraudulent transfers may all be exception creditors and force a distribution, depending on specific state law.

One other point to consider is a recent bankruptcy case (In re Huber), where an Alaska self-settled trust was found to be invalid with respect to the debtor’s creditors in bankruptcy. This case is sure to renew the debate as to whether a true asset protection trust can be created anywhere other than a foreign country, where U.S. courts have no jurisdiction.

Don’t Ask Don’t Tell

Generally speaking, trusts afford families a greater degree of privacy than a will, which is made public during the probate process. In furtherance of the privacies available through trusts generally, Alaska, Delaware, New Hampshire and South Dakota have provisions that allow a trustee to limit disclosure and communication, even among persons or entities with whom the trust has a relationship. Additionally, both Delaware and South Dakota allow certain court filings to be sealed. This prevents records of the filings or proceedings from being made public, and should prevent adverse or other third parties from accessing these records of private family matters.

While lack of communication has been proven to be a factor in the failure to maintain wealth from one generation to the next, there may be circumstances where a grantor would want to, temporarily at least, restrict a beneficiary’s knowledge of a trust’s existence, provisions or assets (e.g., trusts established for very young children or instances where a former spouse would receive notice on behalf of a minor child). Grantors of Delaware and South Dakota trusts may restrict disclosures to beneficiaries (including notifying the beneficiary of the trust’s existence), while trustees in many other states may have a statutory duty to disclose trust information regardless of any language in the trust document to the contrary.
BUT WAIT, THERE’S MORE

Delaware and South Dakota are frequently acknowledged as leaders when considering other state laws relating to trust situs. These include:

- Prudent Investor Rules. Trustees in South Dakota and Delaware have the ability to retain legacy assets without having to adhere to rules of diversification (must be in accordance with the governing document in Delaware). This is in stark contrast to states where trustees have a duty to invest and manage funds as a “prudent investor” exercising “reasonable care, skill and caution.” In some states, there have been cases reinforcing a trustee’s duty to diversify, even though the trust document specifically permitted the holding of a large concentration of a specific stock, possibly frustrating a grantor’s intent. If retention of a family business or other legacy asset is of importance, South Dakota and Delaware may provide the statutory protection for your trust (and trustee) to do so.

- Statutory recognition of trust protectors, directed trusts and special purpose entities. South Dakota and Delaware both have trust protector statutes allowing for greater flexibility in trusts designed to last in perpetuity. A trust protector is an independent third party who can make changes to the trust management and provisions (including adding or removing beneficiaries, removing trustees and changing situs), in order to ensure the grantor’s mission and vision for the trust is realized.

Part in parcel with trust protectors are “directed trusts,” a type of trust wherein the grantor selects a trustee to serve solely as administrator of the trust, without responsibility for managing certain assets. This is often used to allow another more-qualified or aligned advisor to manage specific assets (such as a family business) and provide specific direction to the trustee regarding those assets. South Dakota and Delaware both recognize these types of trusts.

Special purpose entities can be created to provide an extra layer of liability protection for trust protectors and directed trustees. A typical special purpose entity is a limited liability company or corporation formed by the trust protector or directed trustee for the sole purpose of performing their duties. With the entity performing the actions, the protector’s and directed trustee’s liability is limited to their investment in the entity (typically zero or close thereto). An added benefit is that the special purpose entities continue to exist without regard to the death of any one individual. This should reduce the burden of appointing successor protectors and directed trustees. Again, the modern trust laws of Delaware and South Dakota have provisions for these types of entities.

South Dakota also permits private family trust companies and has one of the lowest costs of entry among the perpetual jurisdictions ($200,000 in initial capital). Like the special purpose entities mentioned above, a private family trust company is formed as a limited liability company or corporation. However, unlike the protector or directed trustee created entities, the families, and not their outside advisors, are typically the
In order to make the process of having a court render a decision regarding a trust less burdensome, Delaware, South Dakota and the other remaining perpetual jurisdictions (with the exception of New Jersey) allow for “virtual representation.”

- Virtual representation statutes. In order to make the process of having a court render a decision regarding a trust less burdensome, Delaware, South Dakota and the other remaining perpetual jurisdictions (with the exception of New Jersey) allow for “virtual representation.” Virtual representation eliminates the need for the appointment of a trustee or guardian to represent the interests of unascertainable or unborn beneficiaries. This is especially important when a judicial or non-judicial proceeding involves a trust designed to have no end. Imagine the difficulties of having a guardian appointed (and having that guardian accept her appointment) to represent beneficiaries who may not come into being for thousands of years.

- Decanting provisions. Delaware and South Dakota have also codified decanting. The power to “decant” gives a trustee the ability to transfer trust assets from one trust to another (a second trust governed by a separate instrument), provided certain conditions are met. This power can be especially useful in maintaining a trust’s relevance after the passage of time or occurrence of unforeseen events. Trustees can use this power to decant to a trust with more up-to-date provisions, in a different jurisdiction or one with dispositive provisions that more closely align with the grantor’s mission and vision for the original trust. So long as the exercise of the decanting power falls under one of the safe harbors provided for in the GST Regulations, there should not be a GST tax or change in GST exempt status due to the transfer of assets to the new trust.

- Validity of no-contest clauses. Delaware and South Dakota allow for no-contest clauses in trust documents, intended to reduce the likelihood of litigation in case of disputes and to help cement the validity of the trust’s mission and vision.
PLANTING YOUR FLAG

In the end, the situs decision is not an easy one (after all, in the U.S. alone, there are 50 states plus the District of Columbia to choose from), and only you can decide where your trust will call home.

Selecting your home state as the situs may be a convenient or easy answer. However, the ability to implement a trust that may last forever, eliminate additional transfer taxes after funding (or additional gifts), and avoid state income taxes may provide the financial incentive to stray from home, or at least to consider it.

Looking past the monetary benefits, dynasty trusts can also be used as instruments to make a long-term positive impact on your family and community, thereby securing your legacy (human, intellectual and social capital) for generations to come. It is hard to imagine a more powerful reason to consider one of the perpetual trust states as the situs of your trust.

The protections against creditors (including the ability to create self-settled trusts), privacy provisions and modern trust laws of Delaware and South Dakota set them apart from the rest of the perpetual trust jurisdictions and provide strong reasons to consider them as the state where you plant your trust’s flag.

Selective Analysis of Perpetual Trust Jurisdictions

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<th>PRIVACY - COURT RECORDS</th>
<th>TRUST PROTECTOR STATUTES</th>
<th>DIRECTED TRUST STATUTES</th>
<th>SPECIAL-PURPOSE ENTITY STATUTES</th>
<th>REGULATED PRIVATE FAMILY TRUST COMPANIES</th>
<th>VIRTUAL REPRESENTATION STATUTES</th>
<th>DECANTING STATUTES</th>
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* Resident/Beneficiaries
Straying from Home — The Search for Situs
Michael Malakoff holds a J.D. and an LL.M. and has previous experience as an attorney and tax consultant. He now serves as Managing Director, Wealth Planning for Ascent Private Capital Management of U.S. Bank.

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