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DOMESTIC AND INTERNATIONAL ASSET PROTECTION TRUSTS

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Mario A. Mata, a business and estate planning partner, joined Cantey Hanger LLP after having established himself as a nationally recognized authority on international trusts and related wealth preservation planning. Mr. Mata is a graduate of the University of Texas School of Law in Austin where he received his law degree in 1978. Prior to that, Mr. Mata graduated from the University of Texas School of Business where he received his BBA in Accounting with Honors in 1976.

Mr. Mata has experience in all aspects of business, estate and tax planning for high net worth individuals and families including strategies to efficiently transfer family and personal wealth, both during lifetime and at death, to existing and future generations. However, Mr. Mata is best known for his use of international wealth preservation structures for high net worth individuals. The international structures designed by Mr. Mata are commonly used by high net worth individuals and families to protect assets and family wealth against potential legal claims and other threats to wealth common in today's litigious society. All structures are specifically designed to be fully compliant with U.S. tax laws. Mr. Mata's areas of practice include:

- Domestic and International Trusts and Related Wealth Preservation Planning for Professionals, Executives, Business Owners and High Net Worth Individuals and Families.

- Business and Estate Planning including formation of domestic and offshore family limited partnerships, limited liability companies, Trust Planning including use of Dynasty Trusts, Life Insurance Trusts, Children's Trusts, and related estate planning strategies.

- International Business Tax Planning including foreign entity formation.

- Pre-Marital Wealth Preservation Planning.

Mr. Mata is a member of the International Tax Planning Association and is Vice-Chair of the Asset Protection Planning Committee of the American Bar Association. Mr. Mata was licensed as a Certified Public Accountant (1981-1985) and was board certified in Commercial Real Estate by the Texas Board of Legal Specialization (1991-1999).

Mr. Mata is a frequent speaker on international trust and related wealth preservation topics having made presentations at over 200 legal and tax seminars throughout the United States, Canada and Europe including the American Bar Association's Estate Planning Symposium, the Advanced Estate Planning Conference of the Texas Society of CPA's, the International Trusts Congress in London, and numerous other business, tax and estate planning conferences sponsored by the American Bar Association, the State Bar of Texas, the University of Houston Law Foundation, the University of Texas School of Law, ALI-ABA and numerous other business and estate planning forums. Mr. Mata is also a contributing author to the American Bar Association's book *"Asset Protection Strategies: Planning with Domestic and Offshore Entities"* and has also contributed articles published in *Texas Lawyer* and *The Practical Tax Lawyer.*

IN THE NEWS:

Interviewed and Quoted "***Families Increasingly Turn to Trusts to Protect Assets, Inheritances from Ex-Spouses***" Wall Street Journal, September 22, 2005

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February 6, 2007

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Asset Protection Planning for the Family Business Owner
Estate Planning for the Family Business Owner
ALI-ABA (American Law Institute – American Bar Association)
Santa Fe, New Mexico – July 23, 2004
Boston, Massachusetts – July 15, 2005
Chicago, Illinois – July 21, 2006
San Francisco, California – July 11, 2007

DOMESTIC AND INTERNATIONAL ASSET PROTECTION TRUSTS[1]

Mario A. Mata

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1 A comprehensive discussion of the topics discussed in this paper, including the use of a FLP or FLLC with a self-settled trust to enhance the estate planning benefits of the overall structure, is available in the author's paper entitled "Asset Protection Planning for the Family Business Owner" presented at the Estate Planning for the Family Business Owner" course presented by ALI-ABA on July 11-13, 2007 in San Francisco, California. Copies of the paper may be requested via e-mail from the author at **mmata@canteyhanger.com**.

DOMESTIC AND INTERNATIONAL ASSET PROTECTION TRUSTS

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I. INTRODUCTION

The use of wealth preservation planning to ***legally*** maximize the protection of a client's personal wealth has gained new recognition and acceptance in today's litigious society. Now, more than ever, any business or estate plan requires a careful review and analysis of the risk associated with the client's activities and business holdings.

Every client, no matter how small, should give serious consideration to wealth preservation planning that maximizes the use of the client's personal exemptions available in his or her state. Some states, such as Texas and Florida, have very liberal exemptions. In addition, many domestic wealth preservation vehicles are available to protect family assets from a variety of potential claims. Vehicles such as family limited partnerships and limited liability companies can provide a client with a reasonable amount of protection, at least with respect to the assets owned by such entities. Under certain circumstances, domestic trusts can also provide a significant benefit and advantage in protecting personal assets from creditor claims.

A client's advisor and other professionals must also consider the benefits, goals, issues and risks involved in establishing a domestic or international asset protection trust as part of a comprehensive wealth preservation plan for the wealthy client, business owner or executive with significant business holdings or investments. The benefits of an asset protection trust are all too obvious in those situations when a client without an asset protection trust, but with substantial assets at risk, becomes a defendant in a serious lawsuit. If such a client has not already protected his or her assets with an asset protection trust, the client could face financial ruin.

Unfortunately, many clients and their lawyers never consider the benefits of a domestic or offshore wealth preservation trust until it is too late. A client's advisor should be prepared to adequately advise the client at risk about the benefits of domestic or international trust planning. The businessman turned defendant by a major lawsuit is unlikely to question the merits or moral significance of protecting one's assets with a professionally established offshore trust. If he has not already protected his personal assets with a trust prior to the threat of litigation arising, the client is more likely to ask why his lawyer did not advise him to at least investigate the merits of using an asset protection trust to protect his personal assets. ***In fact, it is this author's belief that failure to so advise a wealthy or at risk client may constitute malpractice if the client's assets are needlessly exposed to a subsequent judgment or other legal claim.***

This paper will focus on the proper use of domestic and international trusts for lawful wealth preservation and tax planning purposes. Multiple tax issues, including reporting requirements and estate planning opportunities, are also discussed. For wealthier clients, such wealth preservation structuring should probably be organized offshore where the client can legally maximize the asset protection goals of his or her overall wealth preservation strategy.

II. DOMESTIC TRUST PLANNING

The domestic trust has been successfully utilized by practitioners as a crucial estate planning and wealth preservation planning tool for decades. Despite restrictions on the ability of a settlor to retain an interest in a trust, a properly structured irrevocable trust, where the grantor has "cut the strings" in terms of benefit and control, has been, and still can be, successfully used to preserve the assets of the grantor for the benefit of his family. There are several advantages to such a strategy.

- **Preservation and Oversight of Interest Gifted to Heir** – The love and affection recited in a gift deed or assignment should not be misconstrued as an endorsement by the parents of a child's ability to manage large some of cash and other assets distributed by a family business entity. By gifting the ownership interest into a domestic trust for the benefit of the family member, a trustee, often a trusted family member, can use his or her best discretion in making distributions to the beneficiary-heir while preserving undistributed funds for the benefit of the future needs of the beneficiary or his or her descendants.

- **Asset Protection Claims Against Children** – If the trust is not involved in any other activity that would subject it to litigation risks, the limited partnership interest transferred to the domestic trust for the benefit of the family member can effectively be protected from the potential creditor claims of the donee family member.

- **Protection From Future Spouses** – Likewise, having the trust own the ownership interest transferred to the domestic trust will protect the donee family member from the claims of future spouses or, if clearly structured as a gift intended to be separate property, from the claims of an existing spouse. This is particularly true in approximately 12 "equitable distribution states" where a divorce court has the power to invade an individual's separate property to award such property to a party in the divorce who the court feels is not at fault in the marriage and will be at an economic disadvantage in attempting to pursue a post-divorce livelihood in light of his or her diminished earnings capacity or net worth. In other words, if a divorce court in such states feels that it is "equitable" to distribute a significant amount of an individual's separate property to the other spouse, such courts are free to do so if it is necessary in order to reach an "equitable" allocation of assets as part of the dissolution of the marriage. Likewise, in many of those same states, a surviving spouse can "elect" to take against a decedent's Will by electing to take a percentage of the decedent's estate in excess of what was provided for in the decedent's Will, even if that should mean invading what is clearly the decedent's separate property in order to fund the "surviving spouse" election.

- **Estate Tax Planning Opportunities** – A properly structured testamentary trust is often provided for in a client's Will for the benefit of the decedent's children or other heirs. While such trusts can and often are drafted to terminate once the beneficiary reaches a certain age, a testamentary trust can also be drafted to last for the lifetime of the beneficiary with the intention that the beneficiary exercise a limited power of appointment, upon his or her death, to leave his or her assets of the estate to such heirs as that beneficiary may elect. If properly structured, such an election can be exercised without risking the possibility that the assets of the testamentary trust will be included in the decedent's taxable estate. Unfortunately, it is in these types of trusts, particularly when a beneficiary can elect to become his own trustee at a particular age, that courts are more likely to find that the trust can be pierced to satisfy creditors or divorce court claims.

A. Spendthrift Trust. One of the most common types of trust used in asset preservation is the spendthrift trust. A spendthrift trust is one that provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The enforceability of a spendthrift trust is usually recognized by state statute which provides that a settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is usually sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary.

Historically, since 1959 until recently, the general rule involving the protection of a beneficiary's interest in a spendthrift trust was found in the Restatement of the Law, 2d, Trust, published in 1959 by the American Law Institute.

1. Restraint on Alienation of Income. The Restatement of Trusts, 2d, provided in §152(1) the right of a beneficiary to receive income from a spendthrift trust was specifically protected from alienation. Specifically it provided that:

> (1) Except as stated in §§ 156 and 157 [of the Restatement], if by the terms of a trust the beneficiary is entitled to the income from the trust property for life or for a term of years and it is provided that his interest shall not be transferable by him and shall not be subject to the claims of his creditors, the restraint on the voluntary and involuntary transfer of his right to the income accruing during his life is valid.
>
> (2) A trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed is a spendthrift trust.

The sole exceptions to the general restraint on alienation of §152 were found in §156 and §157. Section 156 relates to the situation where the settlor is also beneficiary of the trust, in other words, a "self-settled trust" which, to this day, is not favored by the Restatement, although now recognized in eight states. The second general exception to the general rule of §152 is found in §157 which relates to particular classes of claimants who can reach the interest of the beneficiary of a spendthrift trust. Such claimants generally fall into the category of the wife or child of the beneficiary who pursue a claim for spousal or child support or alimony.

2. Restraint on Alienation of Principal. While §152 of the Restatement of Trusts, 2d addressed a restraint on the alienation of income, §153 addressed the restraint on alienation of principal. Specifically, §153 of the Restatement 2d of Trusts provided that:

> (1) Except as stated in §§ 156 and 157, if by the terms of a trust the beneficiary is entitled to have the principal conveyed to him at a future time, a restraint on the voluntary or involuntary transfer of his interest in the principal is valid.

(2) If the beneficiary is entitled to have the principal conveyed to him immediately, a restraint on the voluntary or involuntary transfer of his interest in the principal is invalid.

(3) If the principal is not to be conveyed to the beneficiary during his lifetime, a restraint on the voluntary or involuntary transfer of his interest in the principal is invalid.

The two referenced exceptions to the general rule are identical to those found in §152. Thus, subject to the exceptions of §§ 156 and 157, a trust beneficiary was entitled to have the beneficiary's interest in the principal of the trust protected against voluntary or involuntary transfer if by the terms of the trust the beneficiary was entitled to have principal conveyed to him or her at a future time. Such a principal would essentially ensure that the corpus of the trust that, at some future point in time, might become available to the beneficiary, was protected against alienation prior to the occurrence of that event.

Under a discretionary trust, the beneficiary is entitled only to the income or principal that the trustee, in her discretion, shall distribute to him. G. Bogert, The Law of Trusts and Trustees § 228 (2d ed. 1979). The beneficiary of a discretionary trust cannot compel the trustee to pay him or to apply for his use any part of the trust property, nor can a creditor of the beneficiary reach any part of the trust property until it is distributed to the beneficiary. Id.

B. Discretionary Trust. A discretionary spendthrift trust provides even greater protection to its beneficiaries than a regular spendthrift trust. In a discretionary trust, the trustee has sole and absolute "*discretion*" to decide the amount and the timing of income or principal distributions to the beneficiary. Typically, as long as property is held in trust and is subject to the terms of a spendthrift provision, the general rule is that property may not be reached by the creditors of a beneficiary of that trust. However, once the proceeds are distributed to the beneficiaries, they escape the protection of the clause and may be reached by creditors.[2] However, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity from judicial process.[3] Although the courts will recognize that all property of a debtor shall be subject to reach in proper time and manner by his creditors, save only such

[2] First Northwestern Trust Co. v. IRS, 622 F.2d 387 (1990).

[3] First Northwestern Trust Co. v. IRS, *infra* at 391.

property as may be legally exempt, the courts will generally not extend this policy to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary. Such income does not constitute "property" within the normal meaning of state statutes defining property which is available for execution.[4]

In First Northwestern Trust Co., *infra*, the Eighth Circuit Court of Appeals declined to allow the claim of the Internal Revenue Service to reach the interest of beneficiaries in a family trust where the trustee had broad discretionary powers. The court held that the rights of the beneficiaries were contingent upon the discretionary authority of the trustee. The trust agreement gave the trustee the authority to distribute the trust funds in unequal amounts, and the agreement specifically provided that the trustee was only obligated to disburse "*such amounts as in the sole discretion of the Trustee as necessary, reasonable and proper, to such members of the [settlor's] family requiring such funds upon proper proof of such need to the satisfaction of the Trustee* . . . The court found that there was no identifiable or ascertainable interest or right in the income until those two contingencies were met.

C. The Self-Settled Trust. While trusts have been very popular and widely used in the United States for a variety of purposes, a "self-settled" trust, that is, one that is established for the benefit of the settlor, have been seen as being against public policy and therefore, until recently, prohibited in all 50 states. The general rule against self-settled trusts was found for many years in the Restatement of Trusts, 2nd §156, which provided that:

> (1) Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.
>
> (2) Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

The comments to the rule made it clear that the §156 prohibition against a self-settled trust was applicable even if the transfer into the trust was not a fraudulent conveyance. The interest of the settlor/beneficiary could therefore be reached by subsequent creditors as well as by those who were creditors at the time

[4] First Northwestern Trust Co. v. IRS, *infra* at 392.

of the creation of the trust. It was immaterial that the settlor/beneficiary had no intention to defraud his or her creditors.

The rule against self-settled trusts was re-established in the recently published Restatement of Trusts, 3rd §58, which provides that:

> "A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid."

The foregoing restriction of §58(2) actually appears in the section of the Restatement which, with some exceptions, specifically protects a spendthrift trust that provides by its terms that a beneficiary's interest shall not be transferable by the beneficiary or subject to claims of the beneficiary's creditors.

In the Restatement's comments on the recodification of the rule against self-settled trusts in §58(2), it indicates that "occasional suggestions that the self-settled trust rule be re-examined have been uninfluential, and policy and rules in other areas of the law have been consistent with the rule here." The Restatement did acknowledge limited exceptions such as in the area of pension fund planning, particularly under ERISA.

III. THE DOMESTIC ASSET PROTECTION TRUST ("DAPT")

Notwithstanding the historical rule against self-settled trusts in the United States, the trend to effectively eliminate the common law doctrine against self-settled trusts has followed the trend to reexamine and modify or abolish longstanding common law rules that, in a modern society, are deemed obsolete or no longer necessary.

The first state to go against the traditional prohibition against self-settled trusts was the state of Alaska. On April 1, 1997, Alaska adopted the Alaska Trust Act, House Bill 101. Upon its enactment, the Alaska State Legislature issued a press release entitled "Measure to Strengthen Family Trust Becomes Law." The legislation was ostensibly designed to provide an "onshore" alternative to offshore trusts.

Not to be outdone, the state of Delaware almost immediately thereafter adopted its own legislation on July 9, 1997, when it adopted the Delaware Qualified Dispositions in Trust Act. Since its initial adoption, Delaware has been quite aggressive in regularly amending its statute in an effort to stay one step ahead of its growing competition. Since Alaska started the trend in 1997, seven additional states, thus bringing the overall total to eight states, have adopted legislation that effectively eliminated the common law rule against self-settled trusts and, in its place, adopted asset protection trust legislation expressly sanctioning the Domestic Asset Protection Trust ("DAPT"). The eight states, in order of adoption, are: Alaska (1997), Delaware (1997), Nevada (1999), Rhode Island (1999), Utah (2004), Oklahoma (2004), Missouri (2004), and, effective July 1, 2005, the state of South Dakota. Thus, despite the so-called "public policy" against self-settled trusts, the trend in the Untied States is following the well-established trend in offshore jurisdictions. Specifically, jurisdictions are finding that, for a qualified settlor who is not using such structures to defraud creditors, a self-settled trust is a valid and legitimate structure entitled to the benefits historically granted a non self-settled spendthrift trust.

A. Typical DAPT Statute. Although all DAPT statutes have the same goal, they are by no means identical or even similar. For example, a glaring limitation of the Oklahoma statute is the $1 million "cap" that can be protected in an Oklahoma self-settled trust pursuant to that state's legislation. Also varying from state to state is the statute of limitations on fraudulent transfers (2 years versus 4 years) and the type of assets that can be held in a DAPT and even the location of those assets. Nevertheless, generally speaking, all of the domestic asset protection trust statutes have similar characteristics which include:

- **Self-Settled Trusts Permitted.** State law has been amended by statute to specifically allow the establishment of a "self-settled trust" wherein the settlor can also be a beneficiary of the trust, can receive benefits from the trust and yet protect those benefits from the claims of future creditors. By eliminating the rule against self-settled trust, DAPT states have ***theoretically*** eliminated one of the major obstacles to using a domestic trust for asset protection purposes.

- **Rule Against Perpetuities Abolished.** Admittedly, the Rule against Perpetuities is probably an anachronism that has outlived its usefulness. Most of the offshore jurisdictions have eliminated the Rule against Perpetuities as have some states. Thus, with the elimination or limitation on the Rule against Perpetuities, a DAPT can theoretically continue for several generations and, in some states, forever.

- **Secrecy and Confidentiality Protection.** Some states, such as Alaska, have attempted to adopt strong "secrecy" provisions into their asset protection trust legislation in an effort to protect the confidential nature of the trust and any related information including the identity of the beneficiaries of the trust and the assets of the trust. Of course, such legislation can only go so far. It can defend against the premature disclosure of information relating to the trust while litigation is still pending. Such information is obviously discoverable in a post-judgment environment and certainly discoverable by state and federal authorities. Nevertheless, states like Nevada have extended the right of privacy to the corporate arena by providing, for example, that the officers and directors of a Nevada based company can be "nominees," persons who are disclosed as having and exercising their legal capacity for the company when in fact they are acting on behalf of undisclosed principals. This allows an individual to serve as an officer, manager, or director of a Nevada company without having his or her name disclosed on public documents such as contracts or other documents that might be entered into as part of a business transaction or might actually be even available in the public records.

- **Retained Powers.** Many DAPT statutes allow the settlor of the trust to retain certain powers such as the power to veto distributions, to appoint advisors or trust protectors to the trust, or to retain the power to direct investments or appoint investment advisors to the trust. Some states even allow the settlor to remove and replace a trustee. The foregoing powers are essentially a retained control over the affairs of the trust which, in an offshore setting, would be an invitation to a court to force the settlor holding such powers to exercise them in favor of a creditor. However, in states that have adopted DAPT legislation, these powers are expressly sanctioned by law.

- **Redomiciliation to Offshore Jurisdiction.** As will be discussed below, there is great uncertainly associated with the effectiveness of domestic asset protection trusts. As a result, some states have adopted legislation that expressly allows a trustee of a DAPT to redomicile the trust to a foreign jurisdiction if such redomiciliation is in the best interest of the beneficiaries and consistent with the planning goals of the settlor. By expressly providing in state law that such offshore redomiciliation is sanctioned, the trustee can take steps to effectively remove the trust and its assets from "harms way" by moving the trust offshore without fear of civil liability to the trustee since the redomiciliation is expressly sanctioned by statute.

B. Delaware Asset Protection Trust. Shortly after Alaska adopted the first domestic asset protection trust legislation in the country, the state of Delaware adopted the Delaware Qualified Dispositions in Trust Act ("Delaware APT Statute") effective July 9, 1997, allowing the formation of a Delaware asset protection trust similar to that found in offshore jurisdictions containing statutory asset protection legislation. As with most Delaware business statutes, the Delaware legislature has continued to modify and refine the legislation since its initial adoption.

1. Qualified Dispositions A "qualified disposition" under Delaware law is nothing more than a disposition by or from a transfer to a qualified trustee or trustees, with or without consideration, by means of a trust instrument. A qualified trustee is typically a person:

- who is licensed to act as a trustee by the state of Delaware; or is an individual resident of the state of Delaware;
- maintains or arranges for custody in Delaware of some or all of the property that is transferred to the trust; or
- is not the transferor or a non-resident of the state.

Property that may be transferred to a Delaware trust includes real property, personal property, and interest in real or personal property.

2. Retained Powers of Settlor. The Delaware law provides that a Delaware asset protection trust shall be governed by a "trust instrument" which is an instrument appointing a qualified trustee or qualified trustees for the property that is subject of the disposition. The trust instrument must specifically incorporate the law of the state of Delaware to govern the validity, construction, and administration of the trust. However, what is quite appealing to many individuals are the powers that may be retained by a settlor of a Delaware trust. Of course, to be effective from an asset protection trust, the trust must be irrevocable. However, Delaware law provides that a trust instrument shall not be deemed revocable on account of its inclusion of one or more of the following:

- A transferor's power to veto a distribution from the trust;
- A power of appointment (other than a power to appoint to the transferor, the transferor's creditors, the transferor's estate or the creditors of the transferor's estate) exercisable by will or other written instrument of the transferor effective only upon the transferor's death;
- The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument;
- The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable

remainder annuity trust as such terms are defined in §664 of the Internal Revenue Code of 1986 [26 U.S.C. §664] and any successor provision thereto; and the transferor's right, at any time and from time to time by written instrument delivered to the trustee, to release such transferor's retained interest in such a trust, in whole or in part, in favor of a charitable organization that has or charitable organizations that have a succeeding beneficial interest in such trust;

- The transferor's receipt each year of a percentage (not to exceed 5) specified in the trust instrument of the initial value of the trust assets or their value determined from time to time pursuant to the trust instrument or of a fixed amount that on an annual basis does not exceed 5% of the initial value of the trust assets;

- The transferor's potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of a qualified trustee's or qualified trustees' acting:

  a. In such qualified trustee's or qualified trustees' discretion;

  b Pursuant to a standard that governs the distribution of principal and does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal; or

  c. At the direction of an adviser described in Section 3570(9)(c) of the Delaware APT Statute who is acting (a) in such adviser's discretion; or (b) pursuant to a standard that governs the distribution of principal and does not confer upon the transferor a substantially unfettered right to the receipt of or use of principal.

  For purposes of the above paragraph, a qualified trustee is presumed to have discretion with respect to the distribution of principal unless such discretion is expressly denied to such trustee by the terms of the trust instrument.

- The transferor's right to remove a trustee or adviser and to appoint a new trustee or adviser (other than a person who is a related or subordinate party with respect to the transferor within the meaning of §672(c) of the Internal Revenue Code of 1986 [26 U.S.C. §672(c)] and any successor provision thereto);

- The transferor's potential or actual use of real property held under a qualified personal residence trust within the meaning of such term as described in §2702(c) of the Internal Revenue Code of 1986 [26 U.S.C. §2702(c)] and any successor provision thereto or the transferor's possession and enjoyment of a qualified annuity interest within the meaning of such term as described in Treasury Regulation §25.2702-5(c)(8) 26 C.F.R. 25.2702-5(c)(8)] and any successor provision thereto;
- The transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if such potential or actual receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such taxes and if such potential or actual receipt of income or principal would be the result of a qualified trustee's or qualified trustees' acting:

  a. In such qualified trustee's or qualified trustees' discretion; or

  b. At the direction of an adviser described in the Delaware APT Statute who is acting in such adviser's discretion.

  Distributions to pay income taxes made under discretion included in a governing instrument may be made by direct payment to the taxing authorities.

3. <u>Trust Protector</u>. The Delaware APT Statute allows for the concept of a trust protector similar to that found in offshore jurisdictions. Although the statute provides that only a "qualified trustee" may serve as a trustee of a Delaware asset protection trust, Section 3570(9)(c) provides that while neither the transferor nor any other natural person who is a nonresident of Delaware nor an entity that is not authorized by the law of this State to act as a trustee or whose activities are not subject to supervision as provided in the statute shall be considered a qualified trustee; however, nothing in the Delaware APT Statute precludes a transferor from appointing one or more advisers, including but not limited to:

- Advisers who have authority under the terms of the trust instrument to remove and appoint qualified trustees or trust advisers;
- Advisers who have authority under the terms of the trust instrument to direct, consent to or disapprove distributions from the trust; and

- Advisers described in §3313 of the "Decedents Estates and Fiduciary Relations" provisions of the Delaware Code, whether or not such advisers would qualify as a "Qualified Trustee".

For purposes of the Delaware APT Statute, the term "adviser" includes a trust "protector" or any other person who, in addition to a qualified trustee, holds one or more trust powers.

4. <u>Fraudulent Transfers</u>. Any transfer into a Delaware trust is subject to the fraudulent transfer provisions found in the Delaware APT Statute which incorporate many of the state's normal fraudulent transfer provisions. However, there are significant exceptions. Section 3572 of the Delaware APT Statute provides that no action of any kind, including, without limitation, an action to enforce a judgment entered by a court or other body having adjudicative authority, shall be brought at law or in equity for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless such action shall be brought pursuant to the provisions of §1304 or §1305 of the Delaware Fraudulent Transfers Statute. The Delaware Court of Chancery has exclusive jurisdiction over any action brought with respect to a qualified disposition. However, in any action described in the foregoing sections, ***the burden to prove the matter by clear and convincing evidence is upon the creditor***.

Section 3573 of the Delaware APT Statute provides that, notwithstanding the limitations imposed by §3572, the limitations on actions by creditors to avoid a qualified disposition shall not apply:

- To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt. However, the foregoing exception does not apply to any claim for forced heirship, legitime[5] or elective share; or

- To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the tortious act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable but only to the extent of such claim against

5 "Legitime" is a child's equivalent to the "elective share" of a surviving spouse in a decedent's estate.

such transferor or other person for whom such transferor is or was vicariously liable.

C. Potential Pitfalls and Unresolved Issues. Notwithstanding the obvious advantages of domestic "onshore" asset protection trusts, several obvious issues and many potential pitfalls still exist. The effectiveness of DAPT legislation is not without its share of intelligent and articulate proponents and equally qualified critics. For example, the federal bankruptcy law that has been relied upon to protect a "spendthrift trust" has been cited for the authority that a domestic DAPT will even be recognized in a bankruptcy setting. Bankruptcy Code §541(c)(2) provides that a "restriction on the transfer of a beneficial interest of a debtor in a trust that is enforceable under applicable non-bankruptcy law" is to be honored in bankruptcy. While the foregoing legislation was adopted when all states had a general prohibition against protecting a self-settled trust, even some bankruptcy judges have recently acknowledged in unofficial settings that the foregoing language may require a bankruptcy court to give deference to a domestic asset protection trust. Others would argue that a bankruptcy judge is already required, like a federal judge, to apply the law of the jurisdiction in which the proceedings are pending for purposes of identifying the debtor's interest in property. Thus, if bankruptcy proceedings are commenced by or against a debtor in a state that does not recognize self-settled trusts, it could be argued that the trust is not entitled to the protection of §541(c)(2) since it is not an enforceable trust under the non-bankruptcy law of the state in which the proceedings are pending. Of course, such argument would not be available in a state that actually sanctions domestic asset protection trusts.

There are other disadvantages to a DAPT under current law.

- **Subject to U.S. Jurisdiction.** Trusts and assets located within a DAPT state are still within the jurisdiction of U.S. federal courts. Federal courts have nationwide jurisdiction which is superior to that of any state court. A trustee in a DAPT state will be hard pressed to avoid responding to a federal court's claim of jurisdiction.

- **Full Faith and Credit Clause.** Possibly the biggest legal hurdle to domestic asset protection trusts is the "full faith and credit" clause of the U.S. Constitution which requires that each state of the Union is required to recognize the judgments rendered by the courts of another state. In fact, Alaska and other DAPT states have previously adopted the Uniform Foreign Money Judgments Act.

- **Supremacy Clause.** While federal judges are bound by state law on most matters of substantive law, that certainly does not apply in the case where federal law has preempted state law including (1) matters of federal income taxation and (2) the power and the extent of the jurisdiction and authority of the bankruptcy court and bankruptcy trustee. Clearly assets transferred into a DAPT by a settlor should be reachable by the Internal Revenue Service or other agencies of the federal government to the extent of the settlor's interest in the trust.

D. Future of Domestic Asset Protection Trusts. The mere fact that eight states have effectively abolished the common law rule against self-settled trusts, with more states considering doing so, is evidence of the fact that today's litigious society is moving more and more towards allowing a solvent individual to take steps to protect his or her assets, so long as such action is not being done to delay, hinder, or defraud creditors. In fact, as discussed in the section on Bankruptcy Reform above, Congress clearly had before it the opportunity to effectively eliminate the growing trend toward the use of self-settled trusts both domestically and offshore. Yet, Congress ***expressly*** declined to do so, instead electing to allow a bankruptcy trustee to set aside transfers into such trusts when they are made with actual intent to delay, hinder or defraud and creditor. While domestic asset protection trusts still face many unresolved issues, they are certainly an alternative that should be considered for asset protection purposes, particularly those not inclined to pursue an offshore solution. However, it is too early to tell whether domestic asset protection trusts will be as effective as their proponents hope they are.

Individuals living within states that have actually adopted domestic asset protection trust legislation certainly stand a much better chance of being able to protect their structure than those individuals who reside outside of those states but nevertheless form a DAPT in the hopes that such trusts will eventually be recognized by the U.S. courts. Nevertheless, while there have been at least two cases involving litigation where the validity of a DAPT was placed into question, both cases were settled before trial. Thus, to date, there is no authoritative case law to support the proposition that domestic asset protection trusts will ultimately receive the same level of respect and recognition that is currently available to non self-settled spendthrift trusts.

IV. THE OFFSHORE WEALTH PRESERVATION TRUST

The inherent problems associated with domestic trusts, aggravated by outrageous jury judgments and, in some cases, result oriented courts, have prompted many individuals to seek asset preservation strategies beyond the borders of the United States. Although transfers of assets offshore have traditionally been associated with illegal attempts to evade tax or conceal assets, offshore trusts have become generally acceptable throughout the world as a legitimate means to deal with the many uncertainties in today's world that can result in threats to wealth.

A. Benefits of an Offshore Trust. There are numerous benefits available to using an offshore trust as part of a legitimate asset preservation plan for a client. This is an area of the law that is constantly changing as a result of (i) modernized and progressive asset protection trust legislation enacted by multiple offshore jurisdictions and (ii) constantly changing U.S. laws and court decisions which make it critical that any offshore planning be fully compliant with applicable U.S. tax law and a plethora of federal laws which might be applicable to any proposed transaction. Failure to take into account all possible issues could quickly result in the client not benefiting from the many advantages of an offshore wealth preservation trust. Nevertheless, the following is a brief summary of the advantages of using an offshore wealth preservation trust for the high net worth client or family.

1. Self-Settled Trust Permissible. Most offshore jurisdictions will permit a settlor to establish a self-settled trust wherein the settlor retains beneficial enjoyment or control over the trust assets and/or the administration of the trust, something which is typically not possible in the U.S. Although it is typically a better planning strategy to avoid any unnecessary control on the part of a settlor, the fact that the settlor has retained a beneficial interest in the trust or has a right to exercise certain defined powers in the trust has, in many jurisdictions, been expressly permitted by statute.

2. Chilling Effect of Offshore Trust. A potential creditor and his/her attorney will not welcome the news that a debtor's assets have been sheltered in an offshore trust. An offshore trust constitutes an additional hurdle which the creditor will have to overcome. The mere logistical obstacles presented by the distance of some of these offshore jurisdictions is enough to drive plaintiffs to the settlement table.

3. Non-recognition of Foreign Judgments. Even if a Plaintiff were to obtain a judgment against a Defendant, most offshore jurisdictions will not recognize a foreign judgment. Under the law of most offshore jurisdictions, a creditor must file suit in the jurisdiction in which the trust is located if a creditor intends to enforce a judgment against assets of the trust. Plaintiffs and their attorneys are sometimes surprised to learn that contingency fee arrangements are unique to the United States and, in some offshore jurisdictions, outright illegal.

4. Confidentiality. A legitimate wealth preservation plan contemplates that a debtor will be prepared to make full and complete disclosure, if compelled to do so, regarding the transfers that were made into an offshore trust. Secrecy should never be a necessary element of a legitimate wealth preservation plan. Nevertheless, the traditional cloak of secrecy that is found in most offshore jurisdictions is a benefit which is valued by many U.S. clients who wish to keep a low profile for a variety of reasons. Typically, unless the debtor has committed a crime that is also a crime in the jurisdiction in which the trust is located, an offshore jurisdiction will not provide confidential information about the debtor's affairs without the debtor's consent. Since most offshore financial centers are tax havens with no income or estate taxes, no "tax crimes" are legally possible. Thus, almost all offshore jurisdictions will decline to cooperate with criminal tax investigations of the United States or United Kingdom.

5. Unambiguous Fraudulent Transfer Laws and Statute of Limitations. Few offshore jurisdictions condone a fraudulent conveyance. However, most offshore jurisdictions have attempted to clarify the issue of fraudulent conveyance by drafting clearly defined fraudulent conveyance legislation. This modern legislation has attempted to eliminate many of the ambiguities and unpredictable results that have caused uncertainty for both debtors and creditors alike, both in the United States and in the United Kingdom. Likewise, most jurisdictions have acted to shorten the statute of limitation periods applicable to fraudulent conveyances. (Contrary to popular belief, the Cayman Islands, commonly thought as a debtor haven, has a six year statute of limitations!)

6. Avoids Need For Pre-Marital Agreements. Regrettably, the sacrament of marriage is not as sacred as it once was. It is not uncommon to have a U.S. client that is working on his third marriage. If the client has begun to accumulate wealth, notwithstanding prior divorces, future marriages can continue to be problematic when the issue of prenuptial agreements is first discussed. The need for a pre-marital agreement can be avoided altogether through the establishment of an offshore trust prior to marriage. It not only avoids the unpleasant task of asking a future spouse to sign a pre-marital agreement, it also prevents the need to make the vast financial disclosure that is required under most state laws to make such agreements enforceable. In fact, the future spouse does not even need to know about the existence of the offshore trust. Upon divorce, the assets in the trust are safely and legally outside the jurisdiction of a divorce court.

7. Marital Property and Forced Heirship Laws Overridden. A settlor may be surprised to learn that in most states he will not be able to freely dispose of his property through his Will at the time of his death. Forced heirship laws throughout the United States grant spouses and children of the decedent certain heirship rights in the decedent's estate. These types of problems can be properly addressed through the use of an offshore trust established in a jurisdiction that has adopted legislation to prevent the application of forced heirship laws and forced marital property laws in the debtor's home jurisdiction.

B. Selecting a Favorable Jurisdiction. Great care must be used in selecting the situs of an offshore trust. The availability of the characteristics that must be included in an offshore trust should be specifically identified in the governing legislation of any jurisdiction being considered for the situs of an offshore trust. Among the factors that should be used in evaluating a particular jurisdiction are:

- non-recognition of foreign judgments;
- recognition and protection of self-settled trusts;
- recognition and protection of trusts wherein the grantor has retained significant control over trust assets or administration;
- confidentiality;
- unambiguous fraudulent conveyance laws and favorable statute of limitation periods;
- recognition of trust provisions which override the forced heirship laws or marital property laws of the debtor's home jurisdiction;
- favorable tax law (almost all offshore jurisdictions exempt foreign trust from taxation in their jurisdiction);
- the availability of competent and financially strong trustees;
- the availability of local professional services, including legal counsel;
- the proximity of the jurisdiction to the United States;
- the availability of modern telecommunications, including reliable telephone and communication facilities;
- the compatibility of the offshore jurisdiction to the settlor's language and culture (not all offshore "tax havens" are English speaking); and
- the existence of a modern and stable government.

The forgoing list is by no means exclusive. Some issues will be more relevant to certain clients than others. No two clients are alike. Some clients, such as those on the board of publicly held entities, may be inclined to select what they perceive to be ideal jurisdictions such as the Bahamas or the Cayman Islands. However, although both jurisdictions offer good asset protection, a client who is in a high profile/high visibility position may be better served by selecting a jurisdiction with a low profile such as New Zealand. These are all issues that should be thoroughly discussed with the client before drafting begins.

C. Drafting Considerations. Many of the considerations applicable to the formation of a domestic trust are also applicable to the formation of a foreign trust. Certain considerations, such as the choice of a trustee, are amplified when using a foreign trustee. Rarely is a U.S. client comfortable with the prospect of having his/her assets and wealth subject to the control of an individual or trust company in a foreign jurisdiction. However, in times of crisis, the competency of the trustee will have a significant effect on whether an offshore trust can successfully withstand a creditor attack from the U.S. Moreover, the more the trust arrangement reflects a legitimate arms length arrangement with an independent trustee, the better the benefits to the client from an asset protection standpoint and, if so desired and provided for, an estate planning standpoint.

As with any legal document, a trust agreement for an offshore trust should be drafted to reflect the wishes of the settlor. Although such a trust instrument will include provisions which are typically not found in a domestic trust agreement, a practitioner advising a U.S. client on establishing a foreign trust should first identify the settlor's overall wishes and goals. These desires will then be incorporated into the offshore trust agreement just in the same way as they are in a domestic trust agreement. Of course, any such provisions will have to comply with the law of the offshore jurisdiction that has been selected for the trust. In addition to the foregoing, the trust should include the following provisions:

1. Self-Settled Trust. Assuming it is permissible under the jurisdiction chosen for the situs of the trust, the trust agreement will usually provide that the settlor has and can retain a beneficial interest in the income or corpus of the trust. Great care should be used in selecting a jurisdiction for such a trust as not all offshore jurisdictions will recognize self-settled trusts.

2. Ability to Change Situs of Trust. It is not unusual for a U.S. client to respond unfavorably to the idea of establishing a trust in a jurisdiction that he had never heard of prior to consulting with an attorney. If a settlor genuinely is creditor free or solvent, the U.S. client may prefer to establish his trust in a better known jurisdiction such as the Cayman Islands which may not have ideal legislation. In those cases, this problem can be resolved by a provision in the trust agreement that authorizes the trustees to change the situs of the trust upon the happening of certain unfavorable events. Thus, for example, if a trust is established in Bermuda, a "flee clause" will authorize the trustees in Bermuda to change the situs of the trust to a more favorable offshore jurisdiction if it appears to the trustees in Bermuda that the trust will come under attack in Bermuda as a result of unforeseen problems in the debtor's home country.

3. **Ability to Change Trustees.** The trust agreement should also provide that, upon the happening of certain events, the trustees of the offshore trust may be changed. This can become necessary in a variety of circumstances, not the least of which is a situation where the existing trustee may be found to come under the jurisdiction of a U.S. court. Should that occur, the trust agreement can provide for the automatic removal of the "tainted" trustee and the appointment of a new trustee or trustees.

4. **Ability to Move Trust Assets.** The trustees of an offshore trust should typically be given broad authority to move assets of the trust for specific enumerated reasons. So long as the trustees have a legitimate reason to continue to protect the assets of the trust, the trustees will owe a fiduciary duty to the trust and its beneficiaries to protect its assets by moving them, if necessary, to a more favorable jurisdiction.

5. **Testamentary Disposition Retained By Grantor.** An offshore trust established for wealth preservation purposes must be irrevocable to be effective. On the other hand, the transfer of assets, particularly assets to an offshore trust which is not classified as a "grantor trust" for Federal income and estate tax purposes, can have very adverse tax consequents. Therefore, a typical offshore trust agreement will have characteristics that are specifically designed to qualify the trust as a grantor trust for Federal tax purposes. One significant power, the ability of the settlor to dispose of trust assets by his or her last will and testament, helps classify the trust as a grantor trust but also gives the settlor the comfort of knowing that the ultimate disposition of assets in his or her trust will be determined by his or her last will and testament, a document that can be amended at any time so long as the settlor retains testamentary capacity.

6. **Anti-Duress Clause.** Many asset protection practitioners draft structures that allow the settlor to retain significant control over trust assets, either directly or indirectly. However, the fact that the law of an offshore jurisdiction allows a settlor to retain control of trust assets does not prevent a U.S. settlor from coming under the very effective influence of a U.S. judge. If the U.S. settlor resides in the United States, he is subject to the jurisdiction of its courts. If the settlor has retained the ability to control trust assets, he can be ordered by an American court to exercise those rights and control in a manner which is inconsistent with his goals in establishing the trust to begin with. For example, if a U.S. settlor has retained the right to demand distributions of income or corpus from a foreign trust, a U.S. court can order a settlor under its jurisdiction to exercise those controls in such a way as to repatriate the income or corpus for the benefit of the debtor's creditors. Failure to abide by the court's order will always result in incarceration until the order is complied with. To avoid this potential problem, many practitioners incorporate an anti-duress clause into their trust agreement that is designed to permit the trustee of an offshore trust to ignore the

settlor's demands if the trustee has reason to believe that the settlor has made the request under duress.[6]

7. Use of a Protector. An alternative to an anti-duress clause is the use of a protector. The concept of a protector is typically unknown within the United States, but is common in offshore jurisdictions. The legislation of most offshore jurisdictions recognizes the concept of the protector. A protector is the "guardian angel" of a trust. It is typically an individual who has been granted significant and well defined veto powers over certain proposed actions of the trustee. For example, if a trustee in an offshore jurisdiction should receive instructions from the grantor to repatriate assets of the trust in clear contravention of the settlor's original wishes, the protector has the right to veto such request if the protector, in his sole and absolute judgment, believes that the repatriation of assets would be inconsistent with the settlor's original intent. Powers usually granted a trust protector include the power to:

- remove a trustee;
- cause the trust to relocate to another jurisdiction;
- freeze benefits payable to beneficiaries who have encountered creditor, marital or other problems;
- add beneficiaries, within parameters outlined by the settlor in his or her "Letter of Wishes"; and
- authorize the amendment of the trust amendment to update the document for income or estate tax purposes.

D. Management and Investment of Trust Assets. A common misconception associated with offshore trusts relates to the location of trust assets. While a particular jurisdiction might be ideal for forming an offshore trust, it does not necessarily mean that assets contributed to the trust will be transferred and managed there. On the contrary, assets transferred to an offshore trust are managed where it is logical to do so, particularly liquid assets and investments that are usually managed in an offshore financial center such as the Cayman Islands, Switzerland, or Luxembourg.

6 The benefits associated with the use of a "duress clause" in an offshore asset protection trust should be weighed against the likelihood that such a provision may be found to be offensive by a U.S. court frustrated in its attempts to reach assets of a trust outside its jurisdiction. Some practitioners, including this author, argue that a duress clause is unnecessary if the actions of the Trustee (or request by a beneficiary) are subject to the approval of an independent offshore trust protector.

Assets transferred into an offshore trust can typically be classified as either liquid or illiquid assets. If an individual transfers an interest in an illiquid asset such as real estate or a closely held business, there is typically very little that the offshore trustee is required to do on a day-to-day basis. For example, if the client were to transfer an interest in a limited liability company, closely held corporation, or family limited partnership, the role of the offshore trustee is typically limited to monitoring the interest of the trust in the underlying entity. As a limited partner, the right of the trust to influence the management of the limited partnership is restricted by the limited partnership agreement and by state law. On the other hand, if cash or other liquid assets are transferred into an offshore trust, those assets will typically require close management by a professional asset manager or investment advisor.

1. Cash or Other Liquid Assets. If a large bank or other similar institution is used as trustee of the offshore trust, the trustee itself will typically manage the assets for the trust. For example, if Bank of Bermuda were the trustee of the offshore trust, the investment branch of Bank of Bermuda would handle the day-to-day investment decisions involving trust assets.

A more typical scenario involves an offshore trust company that utilizes the services of a professional asset manager in a top financial center such as the Cayman Islands or Switzerland to manage liquid trust investments. For example, a trust can first be formed in the Cook Islands using one of several reputable trust companies available in that jurisdiction. Once the liquid funds are transferred into the offshore trust, the trustee will arrange to have the funds transferred to a professional asset manager in, for example, the Cayman Islands or Switzerland. That investment manager will then manage the investments on behalf of the trust. The authority of the asset manager is limited to investment decisions involving the management of trust assets. The trustee retains authority over all other trust decisions including the amount and timing of any distributions to the beneficiaries of the trust.

Even though the settlor of the offshore trust is typically also the beneficiary, the settlor will not have any control over the investment advisor. However, the settlor will nevertheless be authorized to have regular communication with the investment advisor in order to monitor the investment activities of the trust.

Obviously, a client contemplating the transfer of cash to an offshore trust will want to have some influence over how those assets are invested by the trust. Unfortunately, that control is typically lost by the settlor when the assets are actually transferred into the trust. Therefore, it is usually advisable for the settlor to inform the trustee and investment manager of his or her investment preferences prior to formation of the trust. Thus, if the settlor prefers that the trustee limit investments of the trust to conservative blue chip stocks and bonds, those preferences can be made clear by the settlor prior to the formation of the trust. Moreover, although the trustee is not required to abide by the beneficiary's investment desires, the offshore trustee is typically authorized and encouraged to seek advice from trust beneficiaries as to their investment preferences. After all, the trust exists for the benefit of its beneficiaries, even if the beneficiary also happens to be the original settlor of the trust.

2. U.S. Advised Offshore Account. Often a prospective client will realize the need to seek offshore asset protection but will be reluctant to abandon the client's U.S. financial advisor who knows the client's investment goals and tolerances better than anyone and has established a confidence with the advisor that may be difficult to easily reestablish with an offshore financial institution that is distant and unknown to the client, notwithstanding their other excellent standing in the world financial community. In those circumstances, depending on several variables, the client's planner may be able to design an international trust structure that contemplates the transfer of the client's portfolio offshore but still provides an investment advisory role for the client financial planner.

A U.S. advised offshore account is an investment account established by the trustee with an offshore financial institution that is nevertheless managed by a U.S. investment advisor. In a typical situation, the liquid assets under management are deposited in a "custodial account" with an offshore financial institution. However, the offshore financial institution merely acts as the "custodian" of the deposited assets and is given no investment authority. Instead, the investment authority is delegated by the trustee to a U.S. based advisor. As such, the U.S. advisor has full investment and management authority over the assets that are deposited in the offshore financial institution. However, the U.S. advisor's authority is ***strictly*** limited to investment management and, thus, will have no authority to disburse funds from the account. That authority is retained by the offshore trustee.

The advantages of a U.S. advised offshore account are obvious. It allows the assets under management to be held in a protected offshore account while being managed by a U.S. based advisor. Such an arrangement allows the settlor easier access to the investment managers of the trust account. Although the settlor retains no control over trust assets, having a U.S. based advisor allows the beneficiaries of the trust to remain better informed about trust investment strategies. Some settlors and beneficiaries also take comfort from the use of a U.S. based investment advisor that may be more familiar to them.

3. Real Estate and Other Non-liquid Assets. Some assets, such as real estate, cannot be easily managed by the offshore trustee and certainly are not subject to being removed from the United States. In those circumstances, the overall wealth preservation plan will typically provide for the settlor to first form a domestic or foreign limited partnership to which the real estate or other asset is transferred. Some planners will then have the settlor transfer all or substantially all of his or her ownership interest in the limited partnership to the offshore trust. The only interest retained by the settlor, if any, is a general partnership interest. The limited partnership interest is thereafter owned by the offshore trust. Other planners will provide for the settlor to retain no interest whatsoever in the FLP or FLLC that is transferred to the settlor's offshore trust. In either event, the trust will receive its pro rata share of partnership distributions. More importantly, upon liquidation of the partnership, the offshore trust will receive its pro rata share of liquidation proceeds that can then be held and invested offshore.

E. The Consolidated Wealth Preservation Trust. As mentioned above and discussed in more detail in the tax section below, a typical offshore trust established by a U.S. person is intentionally drafted to qualify as a "grantor trust" for U.S. tax purposes. Failure to do so will result in a transfer to the trust being treated as (i) a taxable gift, and (ii) a taxable "sale or exchange" of the asset transferred to the trust. However, if established as a grantor trust, any assets held by the trust will be subject to estate tax upon the settlor's death. Thus, even if the primary goal of establishing the trust is the settlor's desire to achieve asset protection for the client and the client family and heirs, the client's planner should consider and integrate into the international trust structure estate planning strategies that will help reduce the estate tax burden of assets held within the trust upon the settlor's death. However, to enhance the likelihood that such planning will succeed, it is important, particularly in an offshore setting, that the resulting structure be established as part of an arm's length transaction with an independent trustee and minimal retained controls on the part of the settlor.

1. Substance over Form: *Strangi and Lawrence*. Case law, both in United States and in sister common law jurisdictions, is replete with examples of courts and judges who have little sympathy for legal structures where the "form" of the structure bears little resemblance to the realities of the situation. A recent example, familiar to all estate planning practitioners, is the recent Tax Court case of Estate of Strangi vs. Commissioner.[7] In Strangi, the estate sought to support valuation discounts, claimed on the decedent's estate tax return, for his interest in the Strangi Family Limited Partnership ("SFLP"). The decedent had transferred virtually all of his wealth to SFLP. After the transfers, Mr. Strangi owned a 99% limited partnership interest in SFLP and a 47% interest in the corporate general partner that owned a 1% general partnership interest in SFLP.

Section 2036(a) of the Internal Revenue Code provides that transferred assets of which the decedent retained *de facto* possession or control prior to death are included in the taxable estate of the decedent. After examining the facts of the case, Judge Mary Cohen found that the facts supported a finding that after the

7 Estate of Strangi vs. Commissioner, T.C. Memo 2003-145, (2003). The case was affirmed on appeal to the Fifth Circuit Court of Appeals. See footnote 97.

formation and funding of SFLP, the decedent, as a practical matter, retained the same relationship to his assets as before formation of the SFLP and it's corporate general partner. In so finding, Judge Cohen remarked:

"the crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets."

The U.S. Fifth Circuit Court of Appeals upheld Judge Cowen's ruling in an opinion issued on July 15, 2005. In its ruling, the Fifth Circuit agreed with Judge Cohen's finding that the transfer of substantially all of the decedents assets into the FLP, leaving few assets available outside the FLP to pay the decedent's living expenses and post-mortem expenses, supported a finding of an implied agreement that allowed the decedent, Mr. Strangi, to retain *de facto* control and/or enjoyment of the transferred assets.[8]

Similarly, in the recent Florida case of In Re: Lawrence, discussed below in the section on *Sham Trusts and Contempt Issues,* the Eleventh Circuit Court of Appeals declined to disagree with a lower court's finding that Mr. Lawrence, the settlor of his trust, had ***"retained de facto control over the trust"*** through his ability to appoint trustees who could, in their absolute discretion, appoint Mr. Lawrence as a beneficiary of his trust and assign the entire proceeds to him.[9]

What these and other cases suggest is that, from both an estate planning standpoint and an asset protection standpoint, the ideal wealth preservation structure is one established at "arms-length" with an independent trustee and established for multiple purposes including estate planning, asset protection, investment diversification and long term preservation and holding of family assets.

2. <u>Settlor as General Partner of a "Drop-Down" FLP</u>. A common planning technique popular with many practitioners incorporates the use of an offshore asset protection trust in conjunction with the formation of a domestic limited partnership. The client initially transfers the assets to be protected to a domestic limited partnership and retains both a general partnership interest and the limited partnership interest. Shortly thereafter, the client transfers the limited partnership interest to an irrevocable offshore trust. However, by retaining the general partnership interest, the client maintains managerial control over the assets transferred to the family limited partnership while protecting the limited partnership interest from the client's individual creditor claims. A similar strategy can be undertaken utilizing the enhanced benefits available through the use of an

8 <u>Estate of Strangi v. Commissioner</u>, No. 03-60992 (5th Cir. July 15, 2005).

9 <u>In Re: Stephan Jay Lawrence</u>, 279 F.3d 1294 (2002).

offshore LP or LLC. Nevertheless, whether using a domestic FLP or offshore FLP, such a strategy contemplates that the settlor will retain control of the FLP through the settlor's ownership and control of the general partner entity.

There are many reasons why a planner may design such a structure for the client. In many circumstances, such a structure may be the only strategy that the client feels comfortable with. In other situations, the assets held by the FLP, such as real estate developments or closely held business interests, may require the active involvement of the settlor in the day-to-day affairs of the entity. Thus, as in Strangi, the client retains control of the FLP even though some or all of the limited partnership interest has been transferred to an offshore trust. In any event, the foregoing strategy may be problematic if estate planning is one of the client's overall planning goals.

3. Consolidated Ownership and Control of FLP by Trust. A more conservative approach, one preferred by this author, provides for both the general and limited partnership interest to be transferred to the international trust.[10] In such cases, the new general partner is typically a new entity, owned and controlled by the international trust. Control of the general partner entity, which in turn controls the entire limited partnership, is then vested in managers appointed and controlled by the offshore trustee, thus striping the settlor of any direct or indirect control over partnership assets. The resulting structure is one where the ownership and control of the FLP has been totally integrated and combined with the international trust. The resulting consolidated wealth preservation trust provides significantly enhanced estate planning benefits and asset protection to the client.

If the client already has a domestic FLP or LLC, particularly one established for estate planning purposes, it is possible to redomicile the entire entity to an offshore jurisdiction that provides enhanced protection for the interest of the partners or members in the entity. Even if part of the ownership interest of the FLP or LLC is already held by other family members, such as domestic trusts established for the benefit of the client's children and grandchildren, redomiciliation can still be achieved. The client's entire remaining interest in the structure, either before or after redomiciliation, can then be transferred to an international trust established by the client.

10 Before adopting such a strategy, the transfer must be planned in a way that does not result in the inadvertent termination of the FLP for tax purposes. A typical asset protection trust is usually drafted to qualify as a tax neutral "grantor trust," resulting in the individual grantor of the trust being treated as the owner of the trust assets for income and estate tax purposes. Thus, if the settlor-beneficiary of the trust is, in an individual capacity, also serving as general partner of a FLP to be transferred to an international trust, a new general partner, one that will be recognized as a separate "person" for tax purposes, must be designated as general partner of the FLP.

The advantages of such a strategy are significant. From an estate planning standpoint, such a structure, if properly designed, implemented and operated, avoids the estate planning problems so often faced by taxpayers in cases such as *Strangi* and others. Of course, the operative requirements are a properly designed, implemented and operated structure drafted with estate planning goals in mind. If done correctly, such a structure will significantly enhance the discounts valuations available to the client, for estate planning purposes, upon his or her death. From an asset protection standpoint, such a structure, again assuming it is properly designed, implemented and operated, will also optimize the asset protection benefits available to the client.

V. COMMON ATTACKS ON FOREIGN TRUSTS

A. Sham Trusts. The concept of a trust is something which is deeply rooted in English common law. The flexibility available in a trust is one of its principal advantages. However, traditional trust law has historically placed limitations on the ability of a settlor to control the affairs of a trust once established. The law contemplates that a trust is an entity separate and distinct from the settlor. To the extent that this distinction is compromised, so will the validity and enforceability of the trust. Thus, a trust in which the settlor has retained significant controls over its affairs can, under traditional English common law concepts, be deemed to be a "sham trust." Consequently, a trust, just like a corporation or other legal entity, can be pierced and disregarded by the courts if it can be proved that the entire structure is a sham not worthy of recognition by the courts. Put another way, the courts will not respect a trust which the settlor does not respect or treat as a separate and distinct entity.

An oft-quoted definition of a sham trust was set out in *Diplock L.J.N. Snook v. London and West Writing Investments, Ltd.,* (1967) 2 QB 786 at 802

> *"...it means acts done or documents executed by the parties to the sham which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual rights and obligations (if any) which the parties intended to create..."*

Notwithstanding the above definition, a sham trust can also occur under a variety of different circumstances, including the circumstance where the parties to a trust agreement never understood the transaction to be a trust or expected the relationship to be governed as a trust.

One of the leading cases in the area of sham trusts is Rahman v. Chase Bank and Trust Company (CI) Ltd. and Others.[11] In the Rahman case, the settlor was a Lebanese businessman who established a trust with Chase Manhattan Bank's Jersey Trust Company. The clear purpose of the trust was to override the forced inheritance and heirship laws of his home country. Upon his death, his wife filed a suit to have the trust set aside as a sham. The Jersey court held that the settlor had retained too much control and considered the trust to be a sham stating, "to give and to retain is not possible." Also fatal to the trust was the failure to carry on the relationship consistent with the trust documents. Testimony was even admitted to show that Mr. Rahman was not familiar with the concept of the trust, particularly since trusts were not common to his country or religion.

B. Contempt of Court: Failure To Repatriate Trust Assets.

While contempt of court is a remedy that has existed in our judicial system for decades, it is only in the last few years that it has been used by U.S. courts in an attempt to reach assets previously transferred into an offshore trust. In two recent celebrated cases, trust settlors who had fraudulently transferred assets into an offshore trust were imprisoned, for 6 months in one case, for failing to abide by a court order to repatriate assets. However, while both cases involved transfers that were apparently fraudulent at the time they were made, the fraudulent nature of the transfers was not legally relevant to the two courts who held the defendants in contempt of court for failure to repatriate assets.

Generally speaking, there are two types of contempt, civil contempt and criminal contempt. Civil contempt is the disobedience of a court order directing an act for the benefit or advantage of the opposing party to the litigation. The purpose of civil contempt is to coerce action or nonaction by a party.[12] Criminal contempt is a commission of a disrespectful act directed at the court itself which obstructs justice.[13]

A person commits contempt of court if they violate a court order of which he has knowledge and which was within the Court's jurisdiction to make.[14] A party's inability to comply with a judicial order constitutes a defense to a charge of civil contempt.[15] Thus, impossibility of performance is a complete defense to a

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11 Rahman v. Chase Bank and Trust Company (CI) Ltd. and Others, (1991) JLR 103

12 17 Am. Jur. 2nd, Contempt, §5 (1997).

13 17 Am. Jur. 2nd, Contempt, §38 (1997).

14 17 Am. Jur. 2nd, Contempt, §130.

15 United States v. Rylander, 460 U.S. 752, 757 (1983).

contempt of court charge. However, the impossibility defense is not available where the inability to comply with the court's order is self-created.[16] In both the *Anderson* and *Lawrence* cases briefly described below, the presiding courts rejected the defense of impossibility from the debtors who claimed complete inability to comply with the court's order to repatriate assets.

Possibly the most significant reported domestic case in the United States involving an offshore trust is the opinion the Ninth Circuit Court of Appeals in FTC v. Affordable Media LLC,[17] commonly known as the "Anderson case," which upheld a decision of a Nevada Federal District Court finding Denyse and Michael Anderson to be in civil contempt for failing to repatriate assets from their Cook Islands trust. While some commentators have used the *Anderson* case as evidence of the risks involving the use of offshore trusts for asset protection purposes, experienced practitioners in the area point to the *Anderson* case as a classic example of the adverse and unintended consequences that can occur to a settlor if a trust is improperly structured.

While the Ninth Circuit Court of Appeals was certainly not sympathetic to the trust that had been established by the Andersons, most experienced practitioners in this area actually agree with the result in the case. In fact, the Anderson case has been seen by many as a model of how ***not*** to form an offshore asset protection trust. For several reasons:

- The Andersons were the trustees of their own trust. Although allowed under Cook Islands law, this is the epitome of poor planning since it places the settlor/trustee in control of his own trust, something which flies in the face of common law concepts of trust law still observed in most countries including the United States.

- The Andersons were their own trust protectors. Once again, it is best to avoid having the client/settlor act as his or her own protector. If a domestic protector is preferred, someone other than the settlor should hold that position such as a friend or family member. Ideally, the protector should be an offshore individual or entity.

- The Andersons ***did*** control their trust. In their capacity as trustees, they were able to repatriate funds at will without the consent of any third party including the withdrawal of $1,000,000 from the trust in order to pay their income taxes.

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16 Ex parte Coffelt, 239 Ark. 324, 389 S.W.2d 234.

[17] FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir. Case No. 98-16378, June 15, 1999)

The Florida bankruptcy case of Stephan Jay Lawrence, *In re Stephan Jay Lawrence*, 227 B.R. 907 (Bkrpcy. S.D.Fla. 1998), and 238 B.R. 498 (Bkrpcy. S.D.Fla. 1999), the debtor was found to be in civil contempt for his alleged willful failure to comply with the specific and definite provisions of the turnover order which required him to turnover to the bankruptcy trustee the assets previously transferred into his offshore trust.

While a strong argument can be made that the finding of contempt in Lawrence is based upon an incorrect interpretation of contempt law, it is doubtful that even a correct legal interpretation could have helped Mr. Lawrence under the circumstances. Mr. Lawrence literally insulted the intelligence of the Court with his flippant and unbelievable testimony. Once the credibility of a debtor is reduced to the level that it was in this case, no amount of legal reasoning can help dig the debtor out of his legal grave, particularly one that he dug for himself. If nothing else, *Lawrence* underscores the absolute necessity of complete and open candor in any court proceedings, particularly bankruptcy and contempt proceedings.

In this author's view, a lawful offshore wealth preservation plan has no need for secrecy statutes nor should it rely on hidden settlor/beneficiary controls to succeed. If the problems of *Anderson* and *Lawrence* are to be avoided, the offshore trust structure should be drafted consistent with the settlor's intentions without allowing the settlor to retain such control over trust assets that might later expose the settlor to a contempt of court problem.

VI. SUMMARY OF OFFSHORE JURISDICTIONS

Possibly the most important decision to be made in establishing an offshore trust is the selection of a home jurisdiction for the trust. All offshore jurisdictions that are active in seeking wealth preservation trusts have also been active in modernizing the law governing such trusts. However, there still exists a broad range of options and differences amongst the various jurisdictions.

Traditional offshore havens, such as the Bahamas and the Cayman Islands, continue to offer a multitude of advantages. However, they are not necessarily the most advantageous jurisdictions, from a trust legislation standpoint. On the other hand, many jurisdictions that have favorable legislation are small and have new but untested legislation.

A. Best Jurisdictions to Use for Establishing an Offshore Trust. As with any legal issue, the ideal jurisdiction for any one particular individual or family will be affected by multiple issues too numerous to discuss in detail here.

There is a wide range of jurisdictions from which to select a situs for the client's trust. The trust law in these jurisdictions can vary significantly.

In recent years, some jurisdictions have adopted very "specific" asset protection trust legislation that is expressly drafted to aggressively protect the assets transferred to a trust by a solvent debtor. Alternatively, other more "traditional" jurisdictions have intentionally decided to avoid such a strategy and, instead, rely upon the common law that has developed over many years within those jurisdictions. Other jurisdictions, sometimes described as "middle of the road" jurisdictions, have elected to adopt moderately debtor friendly legislation to complement their existing common law that has been extensively developed over many years.

The client's individual needs and realities may also affect the choice of jurisdiction. For example, individuals who are on the board of directors of an SEC reporting publicly held company may prefer to use a more traditional or contemporary jurisdiction rather than to use a jurisdiction with more aggressive legislation. On the other hand, most professionals and other individuals involved in high-risk endeavors usually prefer to use a jurisdiction that has very favorable asset protection legislation. In the end, it is the client's advisor who must carefully evaluate the goals and needs of the client when recommending an appropriate jurisdiction for the client.

B. Jurisdictions with "Specific" Asset Protection Legislation. A handful of jurisdictions have adopted legislation specifically designed to provide statutory clarity in the area of asset protection trusts. Typically, strict statutes of limitations exist governing the ability of a creditor to challenge a transfer to an asset protection trust. Although such jurisdictions typically do have fraudulent transfer statutes, a creditor must typically prove, beyond a reasonable doubt, that a transfer to the trust was done with fraudulent intent. Jurisdictions with specific asset protection legislation include the Cook Islands in the South Pacific, Nevis in the Caribbean, and St. Vincent and the Grenadines in the South Caribbean.

C. Traditional and "Middle of the Road" Jurisdictions. Several jurisdictions that have historically relied on traditional notions of trust law have, in recent years, "modernized" their trust law to incorporate the realities of self-settled wealth preservation trusts. However, these "middle of the road" jurisdictions have adopted legislation that, while debtor friendly, is not necessarily as aggressive as that found in jurisdictions such as the Cook Islands. Thus, while these jurisdictions can be considered to have very good asset protection legislation, they have nevertheless retained, for the most part, fundamental common law trust concepts which are considered to be indispensable in many Commonwealth jurisdictions, notwithstanding the modification of the common law by modern trust legislation. Jurisdictions that can be considered to fall into this category include Bermuda, the Bahamas, and the Cayman Islands.

The Channel Island has historically been a favorite of individuals in Europe, particularly the United Kingdom. The Channel Islands include the Isle of Man, Jersey, and Guernsey. The trust law in the Channel Islands relies, to a large extent, on the common law adopted by those jurisdictions from the United Kingdom. Nevertheless, some of these jurisdictions have recently adopted legislation to modernize their existing trust law.

D. New Zealand - A Viable Compromise. New Zealand is not typically considered an "offshore" jurisdiction by practitioners. It has neither asset protection legislation nor is it a tax haven. In fact, it is typically considered a "high tax" jurisdiction like Britain or France. However, New Zealand's close association with the Cook Islands, a progressive trust jurisdiction and former New Zealand protectorate, combined with favorable tax legislation for non-resident trust income, provides some very unique planning opportunities for New Zealand trusts. Some of the principal benefits of a New Zealand trust include the following:

- New Zealand is a well-known and well respected member of the British Commonwealth. It has a modern economy, a democratically elected government, and all of the benefits usually associated with an English speaking democracy. The legal system is based on the English common law model that also forms the basis of the U.S. legal system.

- Although New Zealand does not tax trust income earned outside of New Zealand, it is nevertheless not known as a "tax haven." As a result, it has avoided the scrutiny usually reserved for offshore financial centers, some of which have not had the best of reputations. New Zealand has also avoided the money laundering issues that have plagued many offshore jurisdictions. New Zealand has not been "blacklisted" by any of the major countries that have adopted "anti-money laundering" or "tax haven" legislation. As a result, New Zealand has become very popular with many wealthy Latin American and European families.

- New Zealand has a modern infrastructure. It is accessible by most major airlines and has a communications network as modern as any in the world. Its major metropolitan centers have abundant professional talent available, much of which is educated in the United States, England, and Australia. Most of the major international banks of the world are represented in New Zealand.

New Zealand has a close economic and political association with the Cook Islands, a jurisdiction that arguably has the best asset protection legislation in the world. Should it become necessary, a New Zealand trust can easily be transferred to the Cook Islands, thus benefiting from the strong asset protection safeguards available in the Cook Islands.

E. Switzerland *Finally* Recognizes Trust Law Concepts. While Switzerland is well known as the private wealth capital of the world, what was not commonly known is the fact that Switzerland, a civil law jurisdiction, has historically not recognized the common law trust. Trusts are basically a concept born of Anglo-Saxon common law legal traditions. The term was used to describe a legal relationship in which assets were held by a fiduciary, such as a trustee, for the benefit of the beneficiaries of the trust. Such trustee was responsible for the management of the trust assets or, in some jurisdictions, the delegation of that authority to third parties.

Civil law jurisdictions have historically not recognized the concept of a common law trust. Thus, while Switzerland is the private wealth capital of the world, common law trusts were typically required to open an account in Switzerland in the name of the trustee, typically an entity that was recognized under Swiss law. In other words, the trust opened an account in the name of the corporate trustee although the style of the account referenced the fiduciary relationship between the corporate trustee and the common law trust. Nevertheless, the account was opened for the corporate trustee, not the trust. (For example, ABC Trust Limited, as trustee of the John and Jane Doe Family Trust.)

Nevertheless, the fact that so many common law trusts had assets managed in Swiss banks would often result in litigation which would require Swiss courts to deal with the concept of trusts notwithstanding the non-recognition of trusts under Swiss law.

On December 20, 2006, after years of debate, the Swiss Parliament finally approved legislation ratifying the *Hague Convention on the Law Applicable to Trusts and Their Recognition* which was originally promulgated on July 1, 1985. Thus, it is anticipated that the effective date of the ratification will be sometime in July, 2007.

The fact that Switzerland has ratified the *Hague Convention on Trusts* does not automatically translate into Switzerland having adopted trust law. Quite the contrary is true. By ratifying the *Hague Convention on Trusts*, Switzerland legally acknowledged the validity of trusts and the distinction between legal and equitable ownership. However, unlike it neighbor Liechtenstein, there has not been an immediate groundswell of support for the concept of Switzerland adopting its own "trust law" to govern trusts formed under Swiss law. Instead, Switzerland is in the process of modifying its existing laws which must be modified to account for the lawful recognition of trusts in Switzerland. This includes modifications to Switzerland's bankruptcy law and, while still a work in process, Swiss law applicable to the taxation of trusts. However, the adoption of the *Hague Convention on Trusts* nevertheless opened the door for Switzerland to become a significant player in the trust business as it moves to allow Swiss companies to serve as trustees of a trust formed outside of Switzerland.

The legislation adopted by the Swiss Parliament which ratified the *Hague Convention on Trusts* contemplates that the forum selection clause contained in the trust agreement shall be conclusive for all matters relating to the law of trusts. However, the enabling legislation also allows a trust agreement to designate a Swiss court to have jurisdiction over any or all matters that pertain to the trust where:

(a) one of the parties, the trust, or a trustee is domiciled, or has its habitual residence or establishment in the canton (i.e. state) where that court is located; or

(b) where a substantial part of the trust assets are located in Switzerland.

Thus, assuming the parties to the trust agreement have designated Switzerland as the forum in which all trust disputes shall be resolved, the net effect is to allow a Swiss trust company to act as trustee of a trust which is established pursuant to the law of a foreign jurisdiction, typically a common law trust jurisdiction such as Jersey, Guernsey, or Isle of Man in the Channel Islands, any of the Caribbean common law jurisdictions such as the Bahamas or the Cayman Islands, or other common law jurisdictions, such as Nevis and the Cook Islands, which have adopted specific asset protection trust legislation to govern such trusts. Moreover, in making decisions regarding a dispute involving a Swiss trust, the Swiss courts will be expected to apply the law of the jurisdiction in which the trust is actually organized, so long as doing so is not prohibited under that law or otherwise inconsistent with Swiss law.

VII. U.S. INCOME TAX CONSIDERATIONS

Possibly the biggest myth associated with the use of an offshore trust is that its income is not subject to taxation in the United States. This misconception can probably be traced to two reasons. First, most offshore jurisdiction, such as the Cayman Islands, are “tax havens” that do not tax trusts or business entities established by non-residents in their own jurisdictions. Under the law of most tax haven jurisdictions, all income earned by a foreign trust established by a U.S. citizen is free from taxation in that jurisdiction. However, such tax-free status does not mean the income is not taxable in the United States.

A second reason why offshore trusts established by U.S. citizens are incorrectly perceived to be free of taxation is that most trusts established by Americans abroad do not pay taxes to anyone; all quite illegally. A recent government report indicated that United States citizens are estimated to possess or control $650 billion in accounts established in three popular tax havens, the Cayman Islands, the Bahamas and Luxembourg.

A third and unpublicized reason for this misconception is the careless misrepresentations made by unscrupulous promoters of offshore trusts, in both the United States and offshore. Unfortunately, contrary to popular myth, the income from an offshore trust established by an American settlor is **not** free from taxation in the United States.

A. Typical Grantor Retained Powers in an Offshore Trust. The laws of the offshore jurisdictions that are typically used for wealth preservation trusts promote the concept of preservation of the settlor's wealth for the benefit of the settlor and his family and other beneficiaries. As a result, a typical offshore wealth preservation trust will include the following features which are extremely relevant to the treatment of the trust for United States income and estate tax purposes:

- The settlor is typically the principal beneficiary of the trust. As such, he is entitled to distributions of income and corpus from the trust.

- The settlor's children and other family members are named as members of a beneficiary class also entitled to receive benefits from the trust.

- The settlor, either unilaterally or with a consent of the protector, is entitled to name additional beneficiaries to the trust, not originally named when the trust was formed, at any time during his life.

- Upon the settlor's death, the settlor is often given the authority to exercise a limited or general power of appointment authorizing the settlor to dispose of the trust assets pursuant to his last will and testament.

As will be shown below, these typical wealth preservation trust attributes have a significant impact on how the trust is treated for U.S. income and estate tax purposes.

B. Grantor Trust Rules. A grantor trust is a trust whose income is taxed to the settlor of the trust as a result of certain powers or interests that the grantor may retain upon formation of the trust. For purposes of federal income taxation, the trust is totally ignored. All income and other tax attributes attributable to the grantor trust are taxed directly to the grantor.

Internal Revenue Code §§673-675 provide that trust income will be taxed to the settlor if the following circumstances are present:

- the grantor has retained a reversionary interest in the trust, within certain time limits specified in §673 of the Code;
- the grantor or a non-adverse party has certain powers over the beneficial interest under the trust;
- if certain administrative powers over the trust exist under which the grantor can or does benefit;
- if the grantor or a non-adverse party has the power to revoke the trust or return the corpus to the grantor; or
- if the grantor or a non-adverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse.

C. Application of Grantor Trust Rules to Offshore Trust. The grantor trust rules found in §671-678 of the Internal Revenue Code are specifically made applicable to foreign trusts having one or more United States beneficiaries by Internal Revenue Code §679. In general, §679(a) provides that a United States person who directly or indirectly transfers property to a foreign trust shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of the trust. §679(b) provides that if a foreign trust which did not heretofore have United States beneficiaries subsequently acquires a United States beneficiary, then, the settlor of the trust shall be treated as having income for the taxable year equal to the undistributed net income, at the close of such immediately preceding taxable year, attributable to the property transferred to the trust by the settlor.

D. Estate Tax Consequences. For much the same reasons that a typical offshore trust is treated as a "grantor trust" for income tax purposes, likewise the transfer of assets to an offshore trust will not be deemed to be a completed gift for federal gift and estate tax purposes.

1. Incomplete Gift. Treasury Regulations Section 25.2511-2(c) specifically provides that a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interest of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. In a typical offshore wealth preservation trust, the settlor expressly retains the power to name new beneficiaries to the trust, thus enabling such beneficiaries to enjoy the fruits of the property transferred into the trust. The transfer of the asset to the trust is therefore expressly an incomplete gift under Treas. Reg. §25.2511-2(c).

2. Retained Life Estate. §2036 of the Internal Revenue Code provides that the value of the gross estate of a decedent shall include the value of all property to the extent of any interest therein of which the decedent at any time made a transfer, by trust or otherwise, under which he has retained for his life, or for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death, either (a) the possession or enjoyment of, or the right to the income from, the transferred property or (b) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. Again, in a typical offshore wealth preservation trust, the grantor is the primary beneficiary of the trust. In addition, he retains the right to name additional beneficiaries who may enjoy the fruits of the assets transferred into the trust. Therefore, pursuant to IRC §2036, the transfer to the trust is considered incomplete thus resulting in the property being included in the estate of the deceased settlor.

E. Taxation of Transfers to Foreign Trusts. The Taxpayer Relief Act of 1997 repealed the old excise tax of IRC §1491 and adopted in its place new IRC §684 providing for the recognition of gain on certain transfers to foreign trusts and estates. However, the 1997 legislative revisions did not materially change the taxation of a typical offshore wealth preservation trust. Under new §684(a), any transfer of property by a United States person to a foreign estate or trust is treated as a sale or exchange for an amount equal to the fair market value of the property transferred. The transferor is required to recognize as gain the excess of:

- the fair market value of the property so transferred, over
- the adjusted basis (for determining gain) of such property in the hands of the transferor.

A critical exception to the general rule of §684(a) above is provided by §684(b) that provides that no gain will be recognized to the extent that the foreign trust is treated as a "grantor trust" under IRC §671. However, new §684(c) also provides that if a trust that is not a foreign trust becomes a foreign trust, such trust shall be treated as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust.

Of course, the situation may exist where a settlor may desire to make a "completed gift" for estate tax purposes. However, pursuant to IRC §684, the settlor will have to pay any applicable gift tax upon establishment of such a trust.

That tax can be minimized or eliminated all together if "no-gain" or "high basis" assets, such as cash, are transferred to the trust upon formation. This strategy may be particularly advantageous in situations where the transferred property is expected to substantially appreciate in value.

F. Tax Deferral Using Foreign Non-Grantor Trusts. A significant exception to the "tax neutral" treatment of an offshore trust is a foreign "non-grantor" trust. A foreign non-grantor trust is one that is established outside the United States by a U.S. resident or citizen. It is an irrevocable trust in which the grantor makes a "completed gift" for gift and estate tax purposes. However, in order to be treated as foreign non-grantor for U.S. tax purposes, the trust must not have any U.S. beneficiaries during the life of the settlor and the settlor's spouse, and for a period of one year thereafter. During this time period, the foreign non-grantor trust may have foreign beneficiaries and will typically have at least one foreign charitable organization as a beneficiary. However, during the life of the settlor and the settlor's spouse and for a period of one year after their death, a foreign non-grantor trust will almost always accumulate all income and capital gains and not make any distributions until such time as U.S. beneficiaries are eligible to receive distributions beginning one year after the last to die of the settlor and the settlor's spouse.

1. Offshore Income Not Taxed. The income and estate tax advantages of a foreign non-grantor trust are significant. The foreign non-grantor trust is treated as a "non-resident alien" for United States income tax purposes. Therefore, as such, the foreign non-grantor trust will be taxed only on its U.S. source income. Moreover, if the non-grantor trust is not active in a U.S. trade or business, the capital gains generated within the United States will not be taxable to the trust. If the foreign non-grantor trust has no U.S. source income, it is possible to accumulate income and capital gains from foreign sources tax-free (assuming the income is earned in a tax-free jurisdiction such as the Cayman Islands).

2. Controlled Foreign Corporation Rules Avoided. Another significant benefit of a foreign non-grantor trust is the ability to avoid the "controlled foreign corporation" rules applicable to corporations controlled by U.S. persons. During the period in which the foreign non-grantor trust does not have any U.S. beneficiaries, it will be treated as a non-resident alien and therefore not subject to the controlled foreign corporation rules. As such, the foreign personal holding company income earned by the foreign corporations owned by the foreign non-grantor trust will escape taxation in the United States as earned.

3. Foreign Irrevocable Life Insurance Trust. A typical use of a foreign non-grantor trust is the establishment of a foreign irrevocable life insurance trust. The settlor will typically make gifts of cash to the foreign irrevocable life insurance trust much the same way as is done with a domestic insurance trust. Should the settlor so elect, the generation skipping tax (GST) exemption can be applied to the insurance premiums. Upon the death of the settlor, the entire insurance proceeds will be excluded from the settlor's estate for estate tax purposes. Moreover, if the settlor allocated a portion of his GST exemption to all of the gifts made to the foreign insurance trust, the life insurance proceeds payable upon the death of the settlor will also be free from GST tax.

4. Taxation of Beneficiaries in U.S. To be treated as a foreign non-grantor trust, the trust may not have any U.S. beneficiaries during the life of the settlor or the settlor's spouse, or for a period of one year after their deaths. Once the foreign non-grantor trust acquires eligible U.S. beneficiaries, distributions made to those beneficiaries are taxable in the same manner as distributions from a domestic non-grantor trust. However, any appreciation in the value of the foreign non-grantor trust will have been excluded from the Settlor's estate for federal estate tax purposes.

VIII. FOREIGN TRUST REPORTING REQUIREMENTS

The Small Business Job Protection Act of 1996 changed the definition of a "foreign trust" which is found at IRC §7701(a)(30)(E). After an extensive comment period, the Internal Revenue Service adopted final regulations on February 2, 1999 which can be found at Treas. Reg. §301.7701-7. The revised IRC §7701(a)(30)(E) establishes a two-part objective test for determining, for tax purposes, whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust is treated as a domestic trust. Otherwise, it is treated as a foreign trust for U.S. tax purposes.

A. Reporting Consequences of "Foreign" vs. "Domestic" Trust Classification. The formation of a foreign trust that is classified as such for federal income tax purposes carries with it significant IRS reporting requirements which are accompanied by significant penalties if not complied with. The 1996 revisions to the Internal Revenue Code are basically designed to classify all trusts as "foreign trusts" for reporting purposes unless the trust qualifies as a "domestic trust" for income tax purposes. Notwithstanding the use of the term "foreign trust," the Internal Revenue Service provides clear guidelines by which a trust organized in a foreign jurisdiction can nevertheless qualify as a "domestic trust" for U.S. tax purposes. If the foreign trust meets the qualifications to be classified as a "domestic trust" for U.S. tax purposes, the reporting requirements associated with the trust are greatly simplified and analogous to the reporting requirements of a trust organized in the United States. However, there are strict tests which a foreign trust must meet in order to qualify as a "domestic trust" for U.S. tax purposes. Internal Revenue Code §7701(a)(30)(E) establishes a two-part test for determining, for tax purposes, whether the trust is a foreign trust or a domestic trust for U.S. tax purposes. If both parts of the test are satisfied, the trust is treated as domestic trust.

1. <u>Court Test</u>. Under the first part of the test, in order for a trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must exercise primary supervision over the administration of the trust. The final Regulations provide that the court test is satisfied if:

- The trust instrument does not direct that the trust be administered outside the United States;
- The trust in fact is administered exclusively in the United States; and
- The trust is not subject to an automatic migration provision or "flee" clause.

a. <u>Primary Supervision and Administration</u>. The Regulations also define "primary supervision" to mean that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. The Regulations acknowledge that a court may have primary supervision notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary or trust property. The term "administration of the trust" is defined to mean the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trusts from suits by creditors, and determining the amount and timing of distributions.

b. <u>Automatic Migration Provisions</u>. The Regulations provide that, for purposes of identifying a foreign trust, a court within the United States is ***not*** considered to have primary supervision over the administration of a trust if the trust instrument provides that a United States courts attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States. In one of the examples given in the Regulations, the Regulations speak, used by way of example, of a trust instrument that provides that it is to be administered within the United States but further provides that in the event that a creditor sues the trustee in a United States court, the trust will ***automatically*** migrate from the United States to a foreign country so that no United States court will have jurisdiction over the trust. As a result, a court within the United States is not able to exercise primary supervision over the administration of the trust because the United States court jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction. Therefore, the court fails to satisfy the "court test" from the time of its creation and is a foreign trust for U.S. income tax purposes.

2. **Control Test.** Under the second part of the new test, for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. The term "substantial decisions" is defined by the final regulations to mean those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions.

a. **Substantial Decisions.** Substantial decisions include, but are not limited to, decisions concerning:

- Whether and when to distribute income or corpus;
- The amount of any distributions;
- The selection of a beneficiary;
- Whether a receipt is allocable to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust;
- Whether to remove, add or replace a trustee;
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and
- Investment decisions; however, if a United States person under Section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

b. "Control" by U.S. Persons. The term "control" is defined to mean having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. Under the new regulations, to determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries. Thus, even if a trust had U.S. Trustees that could make all substantial decisions, the existence of an offshore trust "protector" would disqualify the trust from being a domestic trust.

c. Replacement of U.S. Persons. The Regulations contemplate a situation where it may become necessary to replace any person who has authority to make a substantial decision of the trust without jeopardizing the domestic tax status of the trust if the person is replaced within 12 months. In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months from the date of the change to make necessary changes either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the trust's residency. For purposes of the Regulations, an inadvertent change means the death, incapacity, resignation, change in residency, or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change in the residency of the trust but that was not intended to change the residency of the trust.

If the necessary change is made within 12 months, the trust is treated as retaining its pre-change residency during the 12-month period. If the necessary change is not made within 12 months, the trust residency changes as to the date of the inadvertent change. If reasonable actions have been taken to make the necessary change to prevent a change in trust residency, but due to circumstances beyond the trust's control, the trust is unable to make the modification within 12 months, the trust may provide a written statement to the district director having jurisdiction over the trust's return setting forth the reasons for failing to make the necessary change within the required time period. If the district director determines that the failure was due to reasonable cause, the district director may grant the trust an extension of time to make the necessary change. Whether an extension of time is granted is in the sole discretion of the district director and, if granted, may contain such terms with respect to assessment as may be necessary to insure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the district director does not grant an extension, the trust residency changes as of the date of the inadvertent change.

3. Information Reporting Requirements. The Act expanded the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The Act requires the "responsible parties" to file information returns with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements will result in increased monetary penalties.

a. Report of Transfers to Foreign Trust. The Act requires the grantor, transferor, or executor (i.e., the "responsible party") to notify the Treasury Department upon the occurrence of certain reportable events. The term "reportable event" means the creation of any foreign trust by a U.S. person, the direct and indirect transfer of any money or property to a foreign trust, including a transfer by reason of death, and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. A reportable event does not include any transfer of property to a foreign trust in exchange for consideration of at least the fair market value of the property. Also excluded are transfers to certain pension trusts, nonexempt employees' trusts described in §402(b), and charitable trusts. The required return provides information regarding the amount of money or other property transferred to the trust, the identities of the trustee and beneficiaries of the foreign trust, and other items as prescribed by the Secretary of the Treasury.

Any U.S. person that receives (directly or indirectly) any distribution from a foreign trust is also required to file a return to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe. In cases where adequate records are not provided to the Secretary of Treasury to determine the proper treatment of any distributions from a foreign trust, the distribution is includable in the gross income of the U.S. distributee and is treated as an accumulation distribution from the middle year of a foreign trust (i.e., computed by taking the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution, unless the foreign trust elects to have a U.S. agent for the limited purpose of accepting service of process (as described below).

The information required to be filed by the "responsible party" has been incorporated into Form 3520 "Annual Return To Report Transactions With Foreign Trusts And Receipt of Certain Foreign Gifts." Form 3520 is due on the date that the responsible party's income tax return is due, including extensions. A copy of Form 3520 is attached to the responsible party's income tax return. In addition, a copy of Form 3520 must be filed with the Internal Revenue Service Center in Ogden, Utah.

b. Annual Foreign Trust Report. A U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files an annual return to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury. In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or to take testimony, and any summons for such records or testimony, in connection with the tax treatment of any items related to the trust, the Treasury Secretary is entitled to determine the tax consequences of amounts to be taken into account under the grantor trust rules (Internal Revenue Code §§671 through 679). This limited agency relationship is not intended to constitute an agency relationship for any other purpose under Federal or State law.

The annual information reporting requirement is satisfied for foreign trusts by filing Form 3520-A on or before the 15th day of the ***third month*** after the end of the trust's tax year. Extensions of time to file Form 3520-A are available on Form 2758.

In order to authorize a U.S. person to act as an agent under IRC §6048(B), the trust and the agent must enter into a binding agreement, in substantially the format provided by IRS Regulations, which is attached to Form 3520-A.

4. Monetary Penalties for Failure to Report. Under the Act, a person that fails to provide the required notice or return in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, is subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities will result in an initial penalty equal to 5 percent of the gross reportable amount.

In cases involving a transfer of property to a foreign trust, the gross reportable amount is the gross value of the property transferred. In cases involving the death of a U.S. citizen or resident whose estate includes any portion of a foreign trust, the gross amount is the greater of: (a) the amount the decedent is treated as owning under the grantor trust rules or (b) the value of the property includable in the gross estate of the decedent. In cases where annual reporting of trust activities is required, the gross reportable amount is the gross value of the portion of the foreign trust's assets treated as owned by the U.S. grantor at the close of the year, and in cases involving a distribution to a U.S. beneficiary of a foreign trust, the gross reportable amount is the amount of the distribution to the beneficiary. An additional $10,000 penalty is imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury Department notifies the responsible party of such failure. The same penalties are applicable to a failure to report (as required by present law) certain transfers to other foreign entities. Such penalties are subject to a foreign cause exception. The House Committee Report contemplates that the reasonable cause standard will be satisfied upon the showing of reasonable efforts to comply with the reporting requirements. In no event will the total amount of penalties exceed the gross reportable amount.

5. Consequences of Foreign Trust Designation. As discussed above, IRC §684(b) provides that no gain or loss will be recognized upon the transfer of assets to an offshore foreign trust so long as the foreign trust still qualifies as a "grantor trust" for federal income tax purposes. Since a typical wealth preservation trust established under foreign law includes extensive powers retained by the settlor of the trust, such trust will continue to be treated as "grantor trusts" for federal income tax purposes. Thus, should a foreign wealth preservation trust be classified as such under the 1996 Amendment, the only consequence will be the necessity to comply with the reporting requirements promulgated under the new act. However, those reporting requirements are only designed to insure compliance with U.S. income tax laws which a U.S. settlor should already be complying with.

B. Specific IRS Reporting Requirements, Rules, and Forms. There are multiple IRS forms that are required to be filed with the Internal Revenue Service if the foreign trust does not qualify as a domestic trust for U.S. tax purposes. The most important of the IRS forms carries significant monetary penalties for failing to comply with the applicable filing requirements. Nevertheless, the Internal Revenue Service has taken a moderate position when requested to abate penalties where the taxpayer can show "reasonable cause" for failing to comply with the reporting requirements such as when a tax return is not timely filed, is not complete when filed, or, in some cases, not filed at all due to the tax preparer's lack of familiarity with the reporting requirements of a foreign trust.

1. Reporting Requirements of The Trustee. The foreign trustee will be required to file the following forms with the Internal Revenue Service if the trust in question is classified as a foreign trust for U.S. tax purposes:

- **Form 3520-A - Annual Return of Foreign Trust with U.S. Beneficiary.** A foreign trust with at least one U.S. owner must file Form 3520-A in order for the U.S. owner to satisfy its annual information reporting requirements under §6048(b). Each U.S. person treated as an owner of any portion of a foreign trust under §671-679 is responsible for insuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.

  The completed Form 3520-A, including pages 3 and 4, must be filed with the Internal Revenue Service Center in Ogden, UT by the 15th day of the 3rd month after the end of the trust tax year. Thus, for virtually all foreign trusts, Form 3520-A must be filed by March 15th following the end of the calendar year. Copies of the **Foreign Grantor Trust Owner Statement** (page 3 of Form 3520-A) and the **Foreign Grantor Trust Beneficiary Statement** (page 4 of Form 3520-A) must be provided to the U.S. owners and the U.S. beneficiaries by the same due date. However, an extension of time to file Form 3520-A may be requested by filing an application on IRS Form 2758. In practice, an extension for filing Form 3520-A can be obtained through September 15th following the end of the reporting calendar year.

The U.S. owner of the trust is subject to a penalty equal to 5% of the gross value of the portion of the trust assets if the foreign trust fails to timely file Form 3520-A or does not furnish all of the information required by §6048(b). However, no penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

- **Authorization of Agent.** If a foreign trust with a U.S. owner does not have a U.S. agent, the IRS may determine the amounts required to be taken into account with respect to the foreign trust by the U.S. owner. IRC §6048(b)(2). In order to avoid this, a U.S. owner of a foreign trust should ensure that the foreign trust appoints a U.S. agent. A U.S. agent is a U.S. person that has a binding contract with a foreign trust that allows the U.S. person to act as the trust's authorized U.S. agent in applying sections 7602, 7603, and 7604 of the Internal Revenue Code with respect to:

  (1) Any request by the IRS to examine records or produce testimony related to the proper U.S. tax treatment of amounts distributed, or required to be taken into account under the grantor trust rules, with respect to a foreign trust, or

  (2) Any summons by the IRS for such records or testimony.

  In order to authorize a U.S. person to act as an agent under section 6048(b), the trust and the agent must enter into a binding agreement substantially in the format provided in the Instructions to Form 3520-A. A copy of the authorization should be attached to Form 3520-A.

A U.S. grantor, a U.S. beneficiary, or a domestic corporation controlled by the grantor or beneficiary may act as a U.S. agent. However, the IRS will not treat the foreign trust as having a U.S. agent unless the Authorization of Agent includes the name, address, and taxpayer identification number of the U.S. agent. If the person identified as the U.S. agent does not produce records or testimony when requested or summoned by the IRS, the IRS may redetermine the tax consequences of the transactions with the trust and impose appropriate penalties under §6677.

The agency relationship must be established by the time the U.S. person files Form 3520-A for the relevant tax year and must continue as long as the statute of limitations remains open for the relevant tax year. If the agent resigns, liquidates, or its responsibility as an agent of the trust is terminated, a new agent may be appointed pursuant to Section IV(B) of Notice 97-34.

- **Form SS-4 – Application for Employer Identification Number.** Every tax reporting entity must have an employer identification number ("EIN") assigned to it by the Internal Revenue Service. A foreign trust obtains an EIN by filing Form SS-4 with the Internal Revenue Service with the Ogden Service Center. The form must be signed by the trustee, although it can be faxed to the IRS. The Internal Revenue Service will then assign an EIN to the trust. That EIN must be used on all filings with the Internal Revenue Service.

- **Form 1041 – U.S. Income Tax Return for Estates and Trusts.** A typically offshore trust is treated as a "grantor trust" for U.S. tax purposes. Typically, a grantor trust is not required to file Form 1041. However, Treas. Regs. §1.671-4(b)(1) and §1.671-4(b)(6)(II) require that a trust which is organized outside the United States or has any of its assets located outside the United States must file Form 1041 with the Internal Revenue Service.

  Notwithstanding the necessity of filing Form 1041 by a foreign trust, the form is nevertheless a report by a grantor trust, and thus extremely simple to complete. Basically, page 1 of Form 1041 is completed with the appropriate trust identifying information with all amounts reported as "0". Attached to Form 1041 will be a statement reflecting the name and related details of the grantor of the trust, as well as a summary of the income and expenses of the trust. The form must be filed with the Ogden Service Center by the 15th day of the 4th month following the close of the taxable year of the foreign trust. Since the tax year of a foreign trust will correspond with the tax year of the grantor, the due dates for Form 1041 will correspond to the due dates of the grantor's individual tax return.

- **Form 56 – Notice Concerning Fiduciary Relationship.** IRS Code §6903 provides that a person acting in a fiduciary capacity may notify the Internal Revenue Service of such fiduciary capacity and, in the process, provide details regarding the fiduciary's role and contact information.. IRS Form 56 is used for providing the IRS with such notice. There is no penalty provided for failure to file Form 56 and, as a result, it is often not filed by foreign trustees. Nevertheless, the better practice is to request that the foreign trustee file the form at the time that the foreign trust is organized. If the notice is not filed, the Internal Revenue Service is entitled to rely on the last known address of the trust and/or the trustee for purposes of providing notices of any matter related to the trust. Filing Form 56, allows the trustee to, among other things, notify the IRS of a change in address. More importantly, if accompanied by appropriate supporting documentation, such as a copy of a trust deed, the Internal Revenue Service is more likely to not question the authority of an entity acting as trustee of a foreign trust.

  From a practical standpoint, the better practice is to file Form 56 when a trust is initially established. This helps to solidify the role of the trustee as a fiduciary. Moreover, in recent audits of international trusts, it has become the common practice of the Internal Revenue Service to request a copy of Form 56. Thus, even if a trust has been in existence for years, Form 56 should still be sought and filed with the Internal Revenue Service, even if the foreign trust has been in existence for several years.

2. Reporting Requirements of The Settlor of a Foreign Trust. The settlor will be required to file the following forms with the Internal Revenue Service if the trust in question is classified as a foreign trust for U.S. tax purposes:

- **Form 3520 - Annual Return to Report Transactions with Foreign Trust and Receipt of Certain Foreign Gifts.** Any U.S. person that creates a foreign trust or transfers money or property to a foreign trust must report the details of those transfers on Form 3520. Conversely, Form 3520 requires the reporting of any cash or other property that was received by a U.S. person (actually or constructively, directly or indirectly) during the current year, from a foreign trust, whether or not taxable unless the amount is a bonafide loan from the trust, which is reported as such where provided on Form 3520. Form 3520 must be filed with the Ogden Service Center on or before the due date of the individual taxpayer's individual tax return, usually April 15, following the calendar report year. Should the individual grantor receive an extension for filing his or her Form 1040, such extension will automatically extend the filing of Form 3520.

Possibly the most significant provisions of Form 3520 are the penalties associated with failure to file Form 3520 in a timely and complete fashion. Generally, the penalty is:

(1) 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the transfer,

(2) 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution, or

(3) 5% of the amount of certain foreign gifts for each month for which the failure to report continues (not to exceed a total of 25%).

- **Form 709 – Gift Tax Return.** As stated above, a typical offshore trust established for wealth preservation purposes is intentionally designed to qualify as a "grantor trust" for both income and estate tax purposes. As a result, a transfer of assets to a foreign trust is considered to be an incomplete gift under Treas. Regs. §25.2511-2(b). Nevertheless, Treas. Regs. §25.6019-3 requires the filing of a gift tax return. However, the gift tax return will reflect a "0" value for the gift and, as a result, no resulting gift tax liability since the gift is an incomplete gift. If there is no gift tax, there is no monetary penalty for failing to file the gift tax return. As a result, many practitioners do not bother to file Form 709. Nevertheless, the better practice, particularly when attempting to evidence the date of a gift should the settlor become involved in civil litigation, is to file Form 709 with the Internal Revenue Service by its due date, which typically corresponds to the due date of the grantors individual income tax return.

- **Form TD F 90-22.1 - Report of Foreign Bank and Financial Accounts.** Form TD F 90-22.1, also known as a "FBAR," must be filed by a U.S. person if he or she had any financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country. The report does not need to be filed if the assets are with a U.S. military banking facility operated by a U.S. financial institution or if the combined assets in the account(s) are $10,000 or less during the entire year. Form TD F 90-22.1 must be filed by June 30th each year with the Department of the Treasury at the address shown on the form. Form TD F 90-22.1 is not a tax return, hence it is not attached to Form 1040 or any other tax return.

  The American Jobs Creation Act of 2004, effective October 22, 2004, modified existing civil penalties and creating a new one for failure to file a FBAR. For failures to report occurring after October 22, 2004, the penalty for willful failures to report is the greater of $100,000 or 50% of the amount of the transaction or account. If the failure is non-willful, the maximum penalty is $10,000. However, if the government pursues criminal action against a taxpayer for failing to file a FBAR, the result may be a fine, not to exceed $250,000 or 5 years imprisonment, or both. If the failure to file can be shown as being part of an ongoing illegal activity, the fine may be as high as $500,000 and up to 10 years imprisonment, or both.

- **Form 5471 - Information Return of U.S. Persons With Respect to Certain Foreign Corporations.** If a foreign grantor trust with U.S. beneficiaries owns an interest in a foreign corporation, the beneficiaries of the trust, or the Settlor, if deemed to be the "owner" for U.S. tax purposes, may be required to file Form 5471 with his or her Form 1040 individual tax return. Form 5471 is required of a U.S. shareholder who acquires, disposes of, or owns at least ten percent (10%) of the stock of a foreign corporation, or who controls or serves as an officer or director of a "controlled foreign corporation" (IRC §§6038 or 6046). A controlled foreign corporation (CFC) is a foreign corporation, the stock of which is more than 50 percent owned (by vote, or value, at any time during the year) by "U.S. Shareholders." The determination of what constitutes a "controlled foreign corporation" is made pursuant to IRC § 951. Penalties for failure to file Form 5471 can reach $50,000 per occurrence.

IX. CONCLUSION

The uncertainties of our judicial system coupled with the increased exposure to seemingly uncontrollable jury awards has resulted in professional advisors re-examining the benefits associated with the establishment of a domestic or offshore wealth preservation structure for their clients. While a domestic strategy can provide the client with reasonable protection, an offshore wealth preservation structure can provide the client with significantly better protection against ever increasing litigation risk in today's litigious society.