PREMARITAL PLANNING WITHOUT A PREMARITAL AGREEMENT

Use of domestic and offshore entities and trusts to *legally* preserve premarital assets without the benefit of a premarital agreement.

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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. The same strategies that can be used to protect wealth from creditor claims can often be used to protect premarital wealth.

This paper will focus on the proper use of entities and/or domestic and offshore trusts for lawful premarital wealth preservation strategy. Also included is a brief discussion of ancillary entities that are used with trusts to maximize premarital wealth preservation by providing several layers of protection.

Virtually all states provide a comprehensive mechanism by which prospective spouses can enter into a premarital agreement. Unfortunately, as discussed below, the requirements of state laws governing such agreements are many and narrowly construed. Moreover, there is no assurance that parties about to marry will be able to reach an agreement in principal, much less an agreement that complies with the applicable law. In many cases, the issue of a premarital agreement is never broached. This leaves the party with significant assets at risk that assets will become commingled or otherwise claimed to be part of the marital property estate should the marriage later dissolve. Although there are many benefits with having the parties entering into a valid and binding premarital agreement, a party entering a marriage with substantial assets can, in most cases, nevertheless take significant steps to help isolate and protect the separate property status of assets prior to marriage and to protect those assets, if so desired, from the election available under the law of states which allows a surviving spouse to "take against" a decedent's will.

II. MARITAL LAW PROPERTY – GENERAL PRINCIPALS

The marital status of property owned by an individual is governed by state law. Generally speaking, states fall into two categories. Most states, except those classified as "community property" states, are known as "common law" states, as known as "equitable distribution" states. There is a significant difference in the consequences of property ownership in "community property" versus "common law" or "equitable distribution" states. Those differences include the disposition of property upon a subsequent divorce of parties and the distribution of property upon the death of one of the spouses.

A. Community Property.

Community property law derives its roots from Old Spanish martial property law. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Generally speaking, community property is deemed to be all property acquired by the married couple during marriage. The status of the property is community property is ***not*** dependent on which party acquired the property or earned it. Any property purchased or otherwise acquired by a married couple with community property funds is also deemed to be community property. Moreover, all debts incurred by a married couple, regardless of which spouse incurred the debt, is deemed to be community debt.

Upon death or divorce, as a general rule, community property is deemed to be owned equally by both the husband and the wife. However, in a divorce setting, a judge in a community property state typically has the authority to allocate and award community property on a ratio other than 50-50 if such an allocation and award is deemed appropriate under the circumstances, particularly if one spouse has significantly great earning capacity than the other.

A typical example of community property law can be found in Texas where, although based upon the Texas Constitution, it is codified in Chapter 3 of the Texas Family Code. Chapter 3 defines separate versus community property law and all related consequences. Specifically, Section 3.001 of the Texas Family Code provides that a spouse's separate property consist of:

> (a) the property owned or claimed by the spouse before marriage;
>
> (b) the property acquired by the spouse during marriage by gift, devise, or descent; and
>
> (c) the recovery for personal injury sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.

Community property is defined by Section 3.002 as property, other than separate property, acquired by either spouse during marriage. Property possessed by either spouse during or on dissolution of marriage is presumed to be community property. TEX. FAM. CODE ANN. §3.003 (1998). A subscribed and acknowledged schedule of a spouse's separate property may be recorded in the deed records of the county in which the parties, or one of them, reside and in the county or counties in which real property is located. TEX. FAM. CODE ANN. §3.004 (1998).

Not all community property states have identical law. One aspect of Texas law that is different is the treatment of income from separate property. Although it comes as a surprise to prospective spouses and many attorneys, Texas law is clear that income derived from separate property is community property. Arnold v. Leonard, 273 S.W. 799 (Tex. 1925). Therefore, ordinary dividends received from separate property corporate stock, or a distribution from separate property partnership interest are community property. Harris v. Harris, 765 S.W. 2d 798, 802 (Tex. App. – Houston [14th District] 1989 (writ den'd).

B. Equitable Distribution States.

Most states in this country are classified as "equitable distribution" or "common law" states. In an equitable distribution state, property acquired during a marriage typically belongs to the person who earned it or in who's name title of the property is taken. However, upon divorce, the property will be divided between the spouses in a "fair and equitable" manner, hence the term "equitable distribution." Property acquired by either spouse during marriage is typically deemed to be "marital property" and subject to division to the court. In most equitable distribution states, the concept of "separate property" is similar to that found in community states, and recognized by the law and the courts. Therefore, in most cases, even in an equitable distribution state, separate property will not be subject to division upon divorce. However, not all states follow this pattern. Some states will thus take separate property into consideration when dividing property in an equitable distribution state. Moreover, even those equitable distribution states that recognize the status of separate property as such often find that the property has been transformed into "marital property," or will often respect property as "separate property" of one spouse yet expressly take into consideration the value of the separate property in making an "equitable division" of the divorcing party's marital property.

A significant minority of states follow the "all property" concept of property division in a divorce or death situation. In such so called "all property" model states, the courts view a marriage as a merging of two separate estates resulting in the creation of one single estate. Thus, upon a divorce or even death, all such "merged" property is subject to equitable division by the court. Thus, in such "all property" states, a party that brings a significant amount of separate property to the marriage will suddenly find that such separate property has been combined with the marital property of the spouse to arrive at the total amount of property that is divisible by a divorce court. To put it in a cynical view, a person with significant separate property who marries someone with little or no property of their own essentially runs the risk of losing all or a portion of the separate property that belongs to him or her upon marriage. However, even in "all property" states, the courts will generally not attempt to divide property that is owned by "a third party." Thus, even in "all property" states, careful premarital planning can enable an individual to protect his or her separate property from the ravages of divorce through careful planning ***prior*** to marriage.

An excellent analysis of those states that follow the "dual-classification" of property and those who follow the "all property" concept was discussed and identified, by state, in an excellent article by Brent R. Turner, "Rehabilitative Alimony Reconsidered: The 'Second Wave' of Spousal Support Reform," 10 Divorced Litig. 185 (1998), wherein Mr. Turner analyzed the marital property law of 51 American jurisdictions and classified 35 as "dual-classification" states, including 28 equitable distribution states and 7 community property states, and 16 states as "all property" states.

III. PREMARITAL AGREEMENTS

In 1983, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Premarital Agreement Act (UPAA) which has been adopted by 26 states, including Texas and California. On April 17, 1997, the Act was reorganized under Title 1 of the Texas Family Code.

Section 6 of the UPAA governs the enforceability of a premarital agreement. The law provides and exhaustive checklist of requirements that must be met if a premarital agreement is to be enforced as a matter of law. Specifically, Section 6 of the UPAA provides:

> (a) A premarital agreement is not enforceable if the party against whom enforcement is requested proves that:
>
> > (1) the party did not sign the agreement voluntarily; or
> >
> > (2) the agreement was unconscionable when it was signed and, before execution of the agreement, that party:
> >
> > > (A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;
> > >
> > > (B) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and
> > >
> > > (C) did not have, or reasonably could not have had, an adequate knowledge of the property or financial obligations of the other party.
>
> (b) An issue of unconscionability of a premarital agreement shall be decided by the Court as a matter of law.

The requirements of the UPAA are strictly construed in most states. Therefore, to be enforceable under state law, a premarital agreement must strictly comply with the requirements of the UPAA as enacted in that state. In fact, the requirements of the Code are so strict that common practice contemplates that each party's legal counsel will execute the agreement to further evidence the informed consent of the parties entering into the agreement. The many requirements of the UPAA nevertheless make premarital agreements subject to attack well after they are executed.

IV. SURVIVING SPOUSE ELECTIVE SHARE UPON DEATH OF MARRIED PERSON

Most states in the United States allow the surviving spouse of a decedent to take an "elective share" of a decedent's estate. Such an election has the effect of allowing the surviving spouse the right to either (a) accept that part of the decedent's estate that has been left to the surviving spouse by the deceased spouse, or (b) elect to "take against the will" of the deceased spouse by, instead, electing to take a larger share of the decedent's estate as provided by statute. The obvious intent of such elective share statutes is to insure that the surviving spouse receives his or her "fair share" of the decedent's estate, particularly in long-term marriages. There is nevertheless a very broad range of statutes and results that can be found throughout the United States.

In an effort to bring national uniformity to the concept, the National Conference of Commissioners on Uniform State Laws has adopted and continues to update the Uniform Probate Code as a nationally recommended model for the improvement of state law relating to the succession of property at an owner's death, as controlled by will, and intestacy statute, and the probate process.

The general rule under the Uniform Probate Code, which has been enacted by multiple jurisdictions is that a surviving spouse can elect to take under the decedent's will or to take a certain percentage against it. An example of a statute based upon the Uniform Probate Code can be found in Hawaii. The Hawaiian statute gives a surviving spouse the right to take an elective-share percentage amount, determined by a statutorily defined schedule, of the decedent's "augmented estate." *HRS §560:2-202 (2003).* The elective share percentage amount is determined by the length of time that the decedent and the surviving spouse were married. The amount starts at 3% for less than a year of marriage and increases by 3% each year until the 11th anniversary when it jumps by 4% per year until the 15th anniversary when it hits the cap of 50% of the augmented estate. This variable scale is conceivably included to protect against the inequity of a short-term spouse gaining a windfall through the elective share.

Perhaps the most important term set forth and described the Hawaii statute is that of the "augmented estate." Its value consists of:

> (a) the sum of the values of all property, whether real or personal; movable or immovable, tangible or intangible, wherever situated, that constitutes the decedent's net probate estate,
>
> (b) the decedent's non-probate transfers to others,
>
> (c) the decedent's non-probate transfers to the surviving spouse, and
>
> (d) the surviving spouse's non-probate transfers to others. *HRS §560:2-203 (2003).*

This value is reduced by funeral and administration expenses, homestead and family allowances, enforceable claims against the estate, and exempt property. *HRS §560:2-204 (2003).* The Code goes on to elaborate on some of the augmented estate elements put forth in §560:2-203. Most poignantly, §560:2-205 further defines the types of non-probate transfers that are included in the value of the augmented estate. In regards to trusts, it states that the augmented estate includes any irrevocable transfer, made during marriage,

> …in which the decedent retained the right to the possession or enjoyment of, or to the income from, the property if and to the extent the decedent's right terminated at or continued beyond the decedent's death. The amount included is the value of the fraction of the property to which the decedent's right related, to the extent the fraction of the property passed outside probate to or for the benefit of any person other that the decedent's estate or surviving spouse.

HRS §560:2-205(2)(A) (2003). This and the rest of the expansive definition of the augmented estate put forth by the provisions of Rule 2-205 includes any assets which the decedent retained any type of control over or enjoyed any benefits from. However, the crux of this statutory language is the last phrase: "to the extent the fraction of the property passed outside probate to or for the benefit of any person other than the decedent's estate or surviving spouse." Unfortunately, this statute has not been interpreted or tested by Hawaiian courts but it seems to include in the augmented estate any transfers for the benefit of anyone. In fact, this specific provision has only been cited by one case and it was only referenced, not explained. *In re Estate of Searl,* 72 Haw. 222 (1991).

While generally the decedent's intent is given great weight in interpreting a will, almost all common-law states consider spousal disinheritance one of the few instances in which that intent may be modified. Common-law states generally recognize that, regardless of the decedent's intent, the surviving spouse has an interest in the decedent's estate. *19 Ohio N.U.L. Rev. 951 at 954 (1993).* There has been some scholarly concern expressed that the force of the elective sharing statutes gives too much power to the surviving spouse. *2 Conn. L. Rev. 513, 543-45 (1970).* Furthermore, there has been concern that the effect of the strong elective sharing statutes in the context of short-term marriages has somewhat undermined the public policy purpose of ensuring that a long-term spouse is provided for by the decedent's estate rather than by society. However, there is also support for the position that the duty to support arises at marriage regardless of the length of the marriage. *76 Iowa L. Rev. 223, 238 (1991).*

The main differences among the states relate to the definition of the decedent's estate that is available to spousal elective sharing and the percentage of that estate that the surviving spouse has a right to, either one half, one third, or a variable scale like that provided in the Uniform Probate Code. Other idiosyncrasies include limiting the surviving spouse's right to the elective share to a life estate, limiting the use of the elective share to a period of time, and varying the percentage by the number of children of the marriage.

There are sixteen states that utilize the augmented estate concept: Alaska; Arizona; Colorado; Florida; Hawaii; Idaho; Maine; Michigan; Minnesota; Montana; Nebraska; New Mexico; North Dakota; South Carolina; South Dakota; and Utah. In states that retain non-augmented estate elective share statutes, courts use various equitable rules in a case-by-case inquiry into the decedent's use of various will substitutes: under this approach property transferred out of the estate is considered part of the probate estate if the conveyance is "illusory," or if the decedent "intended to defraud" the surviving spouse of his or her marital right in the estate, or if the decedent lacked "present donative intent" with respect to the transfer. *In re Amundson,* 621 N.W.2d 882, at 889 (2001).

The National Conference of Commissioners on Uniform State Laws designed the revised Uniform Probate Code to achieve several goals, one of which was the protection of a surviving spouse's right to a "fair share" of the decedent's estate. *Id.* at 886. Simply stated, the right of a spouse to take an elective share was created to prevent disinheritance of the surviving spouse, *Estate of Karnen,* 607 N.W.2d 32, at 36 (2000)., and the concept of the augmented estate acts to thwart efforts to evade elective share through the use of testamentary substitutes.

Looking to analogous situations dealing with creditors, at least one state, Alaska, enacted statutes in 1997 that seeks to protect irrevocable trusts, and possibly other types, from vulnerability. *Alaska Stat. § 34.40.110(a)-(b) (2004).* Furthermore, Alaska extends this ability to other jurisdictions by providing that the protection afforded by § 34.40.110 would be honored as applied to assets from foreign-out of state-trusts so long as the trust situs is moved to Alaska. *Alaska Stat. § 13.36.043 (2004).* The settlor of the trust cannot retain unfettered control over the trust and enjoy the protection afforded by the statutes but, via the use of a willing trustee, the settlor may still maintain some discretion to use or possess the assets. *48 Drake L. Rev. 769, at 783 (2000).*

Soon after Alaska passed its asset protection legislation, the state of Delaware enacted the "Qualified Dispositions in Trust Act." *12 Del. C. §§ 3570-3576 (1998).* Similar to the Alaska law, the QDTA provides settlors with extensive creditor protection while allowing them to retain a discretionary beneficial interest in the trust. *49 Syracuse L. Rev. 1253, at 1271 (1999).* The Delaware Act contemplates the use of a Delaware trust to allow a married person the ability to protect property that might otherwise be subject to the right of a surviving spouse to elect to take a larger percentage of an estate in "augmented" property states.

V. THE ENTITY THEORY

One of the most important and useful tools in premarital planning is a concept developed in the formulation of corporate and partnership law throughout the twentieth century. The National Conference of Commissioners on Uniform State Laws significantly updated the Uniform Partnership Act in 1994, thereby replacing the original Act adopted in 1914. One of the unanswered issues left open by the 1914 Act was the conflict in partnership law over the nature of the organization. Specifically, the Act failed to address the issue of whether the partnership should be considered merely an "aggregation" of individuals or should it be regarded as an entity by itself. These issues were put to rest in the 1994 UPA which clearly adopted the "entity theory" of partnership law. Section 201 of the UPA (1994) specifically provides that a "partnership is an entity." The recognition of the "entity theory" in determining the marital property rights of spouses plays an important role in premarital planning for an individual with significant separate property to be protected. Under the entity theory, the spouse/shareholder/partner owns an interest in the entity, not in the individual assets of the entity.

A. Limited Partnerships. Under the entity theory of partnership in the Uniform Partnership Act, partnership property is owned by the partnership entity, not the individual partners. Marshall v. Marshall, 735 S.W. 2d 587, 593-594 (Tex. App. – Dallas 1987, writ ref'd n.r.e.). A partner's right in specific partnership property are wholly subordinate to the rights of the partnership entity as owner of the property. The partner may possess the property only for partnership purposes. Partnership property is therefore neither separate nor community in character. Marshall at 594. The only partnership property right the partner has which is subject to community, marital, or separate property characterization is his or her ***interest*** in the partnership. That is the partner's right to receive his or her share of the partnership profits and surplus. Marshall at 594; McKnight v. McKnight, 543 S.W. 2d 863, 867-868 (Tex. 1976). However, distributions of the partner's share of profits and surplus (income) received during marriage might be classified as marital or community property even if the partner's interest in the partnership is separate property. Arnold, Id. Similar concepts apply in the corporate context.

The concept of the entity theory provides significant planning opportunities in a premarital setting. The marital property status of a partnership or corporate interest will depend on the marital property status of the property contributed to the entity in exchange for the interest obtained. Thus, a spouse that transfers separate property to an entity prior to marriage will preserve the separate property status of the property by converting it to an interest in an entity such as a corporation, partnership, or limited liability company. Thereafter, under the entity theory, the income earned by those assets will constitute income of the entity, not income of the individual. As such, the income earned inside the entity will not have marital or separate property status. Thus, both the underlying property transferred to the entity in addition to the income earned by the property inside the entity will be protected as separate property of the contributing spouse.

B. Characterization of Partnership Income. An area of potential confusion and inequity is associated with the treatment of income earned by a partnership. Part of the confusion stems from the federal income tax treatment of partnership income for federal income tax proposes. As can be seen below, it is possible that a spouse will be required to pay federal income tax on income that he or she does not have a legal right to. Hence, the potential inequity.

1. Characterization for Income Tax Purposes. For federal income tax purposes, unless a limited partnership has elected to be treated as a corporation, the limited partnership will be treated as a "conduit" for income tax purposes. In other words, the partnership itself will not pay any tax. The tax will be paid be the partners of the partnership. Typically, the partnership will file an annual income partnership return with the Internal Revenue Service reflecting its taxable income and related deductions. In that return, the partnership will then report the prorata share of taxable income to all of the partners. Each partner is provided a Form K-1 which reflects the amount of income which each individual partner is required to report on their individual income tax return.

It is important to note that each partner is required to report their prorata share of income or loss, ***regardless of whether that income was distributed to the partners or not.*** Thus, by way of example, if a partner's share of partnership income was $100,000, that partner is required to report that $100,000 income on his personal tax return even if the partnership did not distribute a dime of the money to the partner. This can result in significant inequities on a joint tax return if the tax is paid with community property funds.

2. Actual Distributions of Partnership Income. As discussed above, income from separate property, with very limited exceptions, may be classified as marital property. Therefore, under the entity theory outlined in Marshall v. Marshall, 735 S.W.2d at 594, partnership income actually distributed by a partnership to a partner will likely be classified as community or marital property in the hands of the recipient.

3. Undistributed Partnership Income. Again, under the entity theory of the Uniform Partnership Act, and as outlined in Marshall v. Marshall, income earned by the partnership is property of the partnership, not the partners. Thus, as long as partnership income is not distributed, undistributed income will constitute partnership property, and not part of the separate or community property of any underlying partner until and unless the income is distributed to the partners.

The treatment of partnership income can result in significant inequities. As long as it is not distributed, income earned by the partnership does not become part of the marital property estate of the partner. However, because of the different treatment of that income for federal income tax purposes, the partner, whether or not married, must report his or her share of the income from the partnership on his individual income tax return. If married, this "phantom income" will be treated as community property by the Internal Revenue Service. Thus, if a joint tax return in filed, the "non-partner" spouse will effectively be required to report her prorata share of income from the partnership, for tax purposes, despite not having a marital property interest in the income of the partnership under Texas law. If the income is not distributed prior to divorce, the net affect is a depletion of the community property estate as a result of the community estate having to pay income tax on the phantom partnership income that the community estate has never received.

C. Community Right to Reimbursement. To prevent abuse, community property states long ago development a significant line of decisions which holds that the "community" is entitled to reimbursement for time, toil, and talent spend by one spouse for the benefit and enhancement of his or her separate property interest. Jensen v. Jensen, 665 S.W. 2d 107, 109 (Tex. 1984). While the law contemplates that a spouse may expend a reasonable amount of talent or labor in the management and preservation of his or her separate property without impressing a community character upon it, the "community" is entitled to adequate compensation for significant services and talent devoted by the spouse with respect to his or her separate property. If the community does not receive compensation under those circumstances, the community property estate is entitled to "reimbursement" by the spouse that devoted his or her efforts towards the enhancement of the value of his or her separate property. Therefore, when relying on the entity theory to protect the separate property status of a spouse's property, great care should be undertaken to insure that the entity adequately compensates the separate property owner for time and effort expended in maintaining and enhancing the value of his or her separate property.

VI. FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES AS A PREMARITAL TOOL

The family limited partnership ("FLP") has been the staple of estate planning practitioners for years. In recent years, some practitioners have also utilized family limited liability companies ("FLLC") for this purpose. There are a multitude of benefits associated with use of a family limited partnership, including:

- Substantial estate and gift planning opportunities through valuation discounts;

- Ability to avoid "double taxation" of income, as with corporations, since partnerships are "conduit" or "pass through" entities that do not pay income tax;

- Ability to reallocate income from high tax bracket earners to lower tax bracket family members;

- Ability to shelter assets in the partnership and the partnership interests themselves from claims of a partners' creditors;

- Ability to avoid state franchise tax in Texas and other states that have such a tax on corporate entities;

- Ability to consolidate family assets in order to avoid subsequent fractional interest in family assets;

- Provide central control in the general partner which is typically controlled by the patriarch and matriarch of the family;

- Establish a mechanism by which annual gifts can be easily made without fractionalizing family assets;

- Provide a mechanism for the continued ownership of family assets while simultaneously restricting the ability of non-family members to acquire an interest in the FLP and underlying assets;

- Provide flexibility and business planning not available through trusts, corporations, or other business entities; and

- Facilitate the administration and reduced cost associated with a family member's disability or probating a family member's estate.

The overwhelming majority of states recognize the "entity theory" in classifying corporations, partnerships, limited liability companies, and related entities for marital property purposes. Thus, instead of an individual owning the various individual properties held by the entity, the individual is deemed to own his or her share in the entity only. By law, the shareholder/partner does not have an interest in the underlying assets of the entity. Thus, the entity theory presents a excellent opportunity to utilize an entity, such as a limited partnership or limited liability company in those states that recognize the entity theory for marital property purposes.

VII. OFFSHORE FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES - ENHANCED ASSET PROTECTION[1]

Family limited partnerships are probably best known for the significant discounts available when valuing an undivided interest in a family limited partnership for federal gift and estate tax purposes. A less publicized advantage of a family limited partnership is the asset protection features available under the law of many states in the United States. When the goal of the structure is comprehensive wealth preservation, such asset protection features can be just as important as the potential tax savings resulting from the structure. However, what is even less publicized is the fact that virtually all of the foregoing advantages are also available and often enhanced under the laws of several offshore jurisdictions. Thus, a wealth preservation planner seeking to achieve traditional wealth preservation goals with a family limited partnership and related entities can typically achieve those same goals, while achieving a better level of protection for family assets, through the use of offshore limited partnerships and limited liability companies.

As with domestic entities, the asset protection attributes of an offshore family limited partnership derive from statutory as well as non-statutory sources. The limitations and restrictions found within the partnership agreement itself provide various tools that can be used to preserve partnership assets and the interest of the family members in the partnership. Otherwise attractive and valuable assets to a creditor are made less so when they are transferred to and held by a family limited partnership, particularly an offshore FLP. Assuming the partners have respected the family limited partnership as a separate and distinct legal entity separate from themselves, a creditor of one or more partners will be unable to reach partnership assets to satisfy its claim against any of its partners since the assets of the offshore partnership are owned by the partnership, not the individual partners.[2]

Moreover, should the creditor attempt to instead seize the debtor partners' interest in the family limited partnership, the "charging order" limitation found in several offshore limited partnership laws will likewise frustrate a creditor's efforts. The charging order limitations discussed in this paper are made available by statute in several offshore jurisdictions. They significantly limit the recourse

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1 A more comprehensive discussion of the offshore topics discussed in this paper 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 21-23, 2004 in Santa Fe, New Mexico. Copies of the paper may be requested via e-mail from the author at **mmata@canteyhanger.com**

2 Cayman Islands Partnership Law (1995) Revision, § 23.(1).

available to a creditor seeking recourse against a judgment debtor's interest in a partnership. Generally speaking, the partnership interest cannot be seized or sold. Instead, the "charging" creditor becomes a mere assignee of the judgment debtor with respect to his partnership interest. Like many of the domestic counterparts, the partnership law of several offshore jurisdictions generally accords an assignee of a partnership interest little or no rights other than the right to receive distributions made with respect to the "charged" interest. These limitations on the rights of a partner's creditors enhance the value of the offshore family limited partnership as an important family wealth preservation vehicle.

Although relatively new to the offshore arena, the limited liability company ("LLC") is now also available in several offshore jurisdictions. Like its domestic counterpart, the offshore LLC is designed to bring together in a single business organization the best features of all other business forms. Properly structured, its owners obtain both a corporate styled liability shield for its members and the pass through tax benefits of a partnership. However, its asset protection benefits, especially when combined with a FLP, makes the offshore LLC a very valuable asset protection tool when structuring a family wealth preservation plan.

A. Redomiciliation of a Domestic LP or LLC. A typical U.S. client that is a candidate for offshore wealth preservation planning is likely to already own a significant interest in a domestic limited partnership that was initially established for estate planning purposes. Such a domestic partnership is typically controlled by a general partner that is a limited liability entity owned and controlled by the client and various members of his family. Often, assets to be protected are owned by the limited partnership.

Seeking the benefits of an offshore limited partnership usually requires the liquidation of the domestic limited partnership. Doing so may have adverse tax consequences and could result in the transfer being challenged as a fraudulent transfer if one or more partners are subject to legal claims at the time. However, if the domestic limited partnership can be redomiciled to an offshore jurisdiction, many potential problems can be avoided. An excellent example of offshore legislation that allows for redomiciliation is found in the Bahamas Limited Partnership Act is Section 21.(1) of the Act. The Act allows the registration in the Bahamas of an existing limited partnership formed under the laws of a jurisdiction other than the Bahamas. Thus, by way of example, a U.S. limited partnership, formed for either estate planning or asset protection purposes, can be redomiciled to the Bahamas by registering the partnership in the Bahamas as provided by the Exempted Limited Partnership Act. Section 21.(2) specifically provides that registration of a partnership under the circumstances shall not operate:

- to create a new legal entity;

- to affect the property previously acquired by or on behalf of the exempted limited partnership;

- to affect any act or thing done prior to such registration or the rights, powers, authorities, functions or obligations of the exempted limited partnership, any partner or any other person prior thereto;

- to render defective any legal proceedings by or against the exempted limited partnership or any partner or any other person and any legal proceedings that could have been continued or commenced by or against the exempted limited partnership or any partner or any other person before its registration hereunder may notwithstanding such registration be continued or commenced after such registration and in respect of which such Acts or laws of such other jurisdiction shall be of application.

This provision in Bahamian law is extremely useful as it allows the transfer to the Bahamas of a pre-existing partnership formed in the United States without the need of dissolving and liquidating the partnership. Doing so allows the partnership to continue as a legal entity, without interruption, from both a legal and tax standpoint. This is particularly important if the transfer is being undertaken at a time when one or more of the partners have encountered legal issues. By avoiding the dissolution and liquidation of the partnership, transfers that occurred to the partnership prior to the individual partner or partners encountering legal problems should not be subject to challenge as fraudulent transfers.

Some offshore jurisdictions similarly allow the redomiciliation of an LLC. For example, as in the Bahamas, Nevis law accommodates the redomiciliation into Nevis of a LLC formed under the laws of a jurisdiction other than Nevis so long as the law of *that* jurisdiction does not prevent such a redomiciliation. The redomiciliation process is commenced by filing an "Application to Transfer Domicile" with the Registrar of Companies[3] Once the LLC is redomiciled to Nevis pursuant to the Nevis Limited Liability Company Ordinance, the entity is treated for all purposes as the same entity that existed before the redomiciliation.[4]

B. <u>Drafting Strategies</u>. U.S. practitioners are often surprised to learn that the law of several offshore jurisdictions easily accommodate U.S. style partnership agreements for LPs and operating agreements for LLCs.[5] Often, it is

3 Nevis Ltd Liab Co Ordinance §66

4 Id., §70(1)

5 LLC's are known as limited duration companies in some offshore jurisdictions such as the Cayman Islands.

not uncommon for a practitioner to be able to use an agreement format that is familiar to the practitioner but is modified to conform to local law. Hence, virtually all planning strategies that can be incorporated into a domestic limited partnership agreement or operating agreement can likewise be incorporated into an offshore LP or LLC agreement.

C. U.S. Tax Treatment of the Offshore LP and LLC. The popularity of limited partnerships in the United States is due, in no small part, to the conduit or "flow-through" tax attributes of the entity for U.S. income tax purposes. A limited partnership is required to file an information tax return with the IRS but partnership income is reported pro-rata by partners. Likewise, a domestic LLC with two or more members is typically treated as a partnership for U.S. tax purposes. However, while such treatment of domestic LPs and LLCs is automatic in the U.S., the exact opposite is true when dealing with offshore LPs and LLCs.

Great care must be undertaken when seeking conduit tax treatment in the U.S. for a foreign limited liability company or limited partnership. Under U.S. tax law, a foreign limited partnership or limited liability company will automatically be taxed as a corporation unless the entity affirmatively elects to be treated as a conduit entity for U.S. tax purposes. The election is made pursuant to the IRS "check-the-box" regulations[6] by timely filing Form 8832 with the Internal Revenue Service. If the proper and timely election is made, a foreign single member LLC may elect to be treated as a disregarded entity, or as a partnership if the LLC has more two or more members. A foreign limited partnership must likewise file an election to be treated as a partnership for U.S. tax purposes.

VIII. CLASSIFICATION OF TRUSTS

A. Legal Character of Interest in Trust. The concept of a trust provides for the "beneficial" ownership of trust assets to be separated from legal title. Hence, the trustee will typically hold "legal title" to the property whereas the beneficiary will have only a beneficial interest in the trust. Moreover, if the trust is a discretionary trust, the trustee will typically have the sole discretion to determine the extent to which the beneficiary will enjoy the beneficial interest in the trust. In any event, whether the trust was created prior to marriage or after marriage, an individual beneficiary, unless he or she is also the trustee, will not have legal title to the trust or trust assets. As such, it is not part of the marital estate.

B. Trusts Created Prior to Marriage. Whether a beneficial interest in a trust is separate property or community or martial property is based upon the "inception of title" rule. Hence, a beneficial interest in the trust owned or

6 Treas. Regs. 301.7701-3.

acquired prior to marriage shall be the separate property of that beneficiary in most states.

As with any trust, it is important that all of the requisite formalities associated with the trust be recognized by all parties, particularly the settlor/beneficiary of the trust, in order to protect the trust and its assets. Even those states that recognize assets of a trust as being assets owned a "third party," will not hesitate in including the assets of the trust in a marital division if it is shown that the trust is nothing more than the alter ego of the settlor beneficiary. The more control that an individual may have over a trust, the more likely that a court will not hesitate ignoring the existence of the trust for any purpose, whether it be asset protection or the division of marital property. Thus, while the law of domestic jurisdictions such as Delaware and Alaska, as well as most offshore jurisdictions, allow the settlor to have varying degrees of control over the trust and its assets, it is this author's opinion that any amount of significant control on the part of a settlor/beneficiary will jeopardize the settlor's ultimate goal for establishing the trust in the first place.

IX. THE OFFSHORE TRUST ALTERNATIVE

The uncertainties of domestic marital property laws have prompted many individuals to seek asset preservation mechanisms 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, foreign situs trusts have become generally acceptable throughout the world as a legitimate means to deal with the uncertainties of an unpredictable judiciary. However, they have also become an ideal strategy to preserve premarital assets.

There are numerous benefits available to using a foreign situs 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 more aggressive wealth preservation trust legislation passed by various offshore jurisdictions and (ii) changing U.S. laws and court decisions apparently in response to the ever increasing use of offshore trusts by U.S. citizens. Nevertheless, a brief summary of the advantages of using a foreign situs trust is as follows.

A. Benefits of an Offshore Trust

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**. Although primarily psychological in nature, a potential claimant and his/her attorney will not welcome the news that an individual's assets have been sheltered in an offshore trust. An offshore trust constitutes an additional hurdle which the claimant will have to overcome. The mere logistical obstacles presented by the distance of some of these offshore jurisdictions is enough to drive claimants to the settlement table.

3. **Non-recognition of Foreign Judgments**. Even if a Claimant 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 claimant must file suit in the jurisdiction in which the trust is located if a claimant intends to enforce a judgment against assets of the trust. Claimants 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 trust settlor 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 which 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 trust settlor has committed a crime which is also a crime in the jurisdiction in which the trust is located, an offshore jurisdiction will not provide confidential information about the trust settlor's affairs without the trust settlor'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 which have caused uncertainty for both trust settlors and claimants 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 Premarital 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 premarital agreement may 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 premarital 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 as a result of surviving spouse statutes. 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 trust settlor'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 which must be included in a foreign situs 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 trust settlor'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.

X. STRUCTURING AN OFFSHORE WEALTH PRESERVATION TRUST

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 claimant attack from the U.S.

A. Significant Offshore Trust Provisions. As with any legal document, a trust agreement for a foreign situs 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 which 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 which 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 which 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 settlor'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 which 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. **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 recognize 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.

B. 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.

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 which 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. 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 is transferred. Shortly thereafter, the settlor will transfer 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. As such, the trust will receive its prorata share of partnership distributions. More importantly, upon liquidation of the partnership, the offshore trust will receive its prorata share of liquidation proceeds that can then be held and invested offshore.

XI. 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 a foreign situs 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 which 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 which 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 Foreign Situs 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. Section 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.

XII. CONCLUSION

The uncertainties of our judicial system and domestic marital property laws has resulted in professional advisors examining the benefits associated with the establishment of a domestic or offshore wealth preservation structure for their clients. While such structures can provide a multitude of benefits, they should only be used under specific circumstances. Both the client and the client's advisor must be fully knowledgeable of the risks associated with the establishment of such a wealth preservation structure and the consequences of establishing such a structure under the wrong circumstances. Use of a wealth preservation structure in an attempt to or as part of a scheme to defraud an existing spouse will, in most cases, fail outright, and in the worst case, result in potential civil liability to the client and the client's attorney. Nevertheless, with careful planning, a domestic or offshore wealth preservation structure can provide the client with significant protection against the uncertainties associated with a division of assets upon a divorce.

MARIO A. MATA

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 domestic and 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.
- Premarital 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 numerous legal and tax seminars throughout the United States and Canada 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.*

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