DECOSIMO GLOBAL

ASSET PROTECTION STRATEGIES

DOMESTIC AND FOREIGN APPLICATIONS

ASSET PROTECTION TRUSTS, IN GENERAL

DECOSIMO's concept of "asset protection planning" embodies the reality that estate planning by its very nature has always implicitly embodied the asset protection planning exercise-the preservation and transmission of wealth. Before 1980, the primary focus in the United States was on minimizing taxes, although, since the early days of trust law, originating in the United Kingdom, the overriding goal has been the security and protection of wealth.

Fundamental to the common law of trusts is the concept of wealth management for the benefit of the beneficiary whose enjoyment might otherwise be compromised or threatened by disability, inability, compelling commitments, personal factors, or external threats. Thus, a dominant and natural theme of trust law is asset protection planning.

Opportunities abound in domestic legal vehicles such as corporations, limited partnerships, limited liability companies, limited liability partnerships, trusts, retirement plans, life insurance, annuities, homesteads, spousal arrangements, inheritances and foundations, with permutations and combinations of these popular entities offering even more opportunities. Furthermore, certain entities may be separated into multiple entities in order to achieve superior asset protection {i.e., using limited partnerships in conjunction with trusts, and corporations or limited partnerships, formed in hospitable domestic jurisdictions}.

The law of fraudulent transfers and bankruptcy preferences must be fully considered in connection with both domestic and foreign asset protection planning, as one can no more move wealth into asset protection trusts to avoid legitimate claims of creditors than one can otherwise transfer or conceal assets to defeat creditors' rights. The statutory law regarding fraudulent transfers derives from the 1570 Statute of Elizabeth, which most notably, declares as "utterly void", conveyances, alienations, etc., "designed to delay hinder or defraud creditors", making it the historical model for modern fraudulent transfer statutes. The general principle upon which fraudulent transfer law rests is that if a court determines that the transfer was fraudulent, a creditor can have the transfer set aside.

There are three categories of creditors, which should be considered when planning asset protection strategies including present creditors, potential subsequent creditors and, the unknown future creditor. The use of an offshore trust arrangement is appropriate in a variety of situa-

tions and circumstances, but the two reasons most often expressed by U.S. resident persons are asset protection and meaningful economic diversification. Properly structured, an offshore trust can readily serve the dual roles of an asset protection entity and a vehicle for implementation of an internationally diversified investment portfolio.

Because it is jurisdictionally severed from its domestic situs, an offshore trust arrangement is less likely than a domestic trust to be targeted as a source for satisfying a future judgment or claim, with the inherent difficulty in accessing the trust, both physically and legally, possibly influencing a potential future claimant's decision to pursue an action, or at least incline the claimant to perhaps settle in ways more favorable to the defendant. Because locating the arrangement in an offshore venue makes it substantially easier for a potential settlor to expatriate, the offshore environment serves the purpose of "keeping options open" for forward-looking investors, as an offshore venue will generally establish a new set of financial and legal relationships and will expedite further movement of the investor's wealth to a new base in the event the decision is made to expatriate..

Foreign asset protection trusts are tax neutral as they are generally not established for income or estate tax savings, but rather for asset protection purposes. A domestic asset protection trust should be established such that it switches into the foreign mode from the domestic mode when there is a creditor problem or threat thereof, and upon this triggering event, the trust will take on the character of a foreign trust.

SELECTION OF OFFSHORE JURISDICTION

In the selection of an offshore jurisdiction in which to "settle" an asset protection trust, great weight should be given to political and economic stability. Although economic stability is typically integrated with political security, this is not always the case. The ideal locale should have a certain economic substance measured by the status of its population, domestic output, infrastructure, and professional community, with a healthy range in the choices of banks, accountants, trustees, attorneys, and investment advisors providing some level of proof of a comforting level of professional and economic activity.

As a general rule, reputable professionals in foreign jurisdictions have reasonable charges. Transportation and communications are extremely important characteristics of an ideal offshore jurisdiction in which to settle an offshore asset protection trust, and sometimes, even personal tastes are a factor in the selection of a jurisdiction. Most offshore trust structures require the

participation of a foreign custodian bank and accordingly, thorough inquiries should be conducted regarding the bank's reputation, integrity, and fiscal solidity.

EXPORTING THE ASSETS v. IMPORTING THE FOREIGN LAW

The first method is to place the assets in a foreign jurisdiction with a foreign trustee and arrange the entire transaction to sever all jurisdictional ties with the United States' federal and state judicial systems. This approach requires a subsequent claimant or creditor seeking to satisfy a U.S. judgment to travel to the selected jurisdiction in an effort to enforce the claim. The foreign environment may well present a stage where chances of a claimant's success are bleak as well as costly, and is known as "exporting the assets" to a foreign trust. If the assets are physically offshore, a claimant or creditor pursuing the assets of a foreign trust typically will have to do so in a jurisdiction under which the trust was created. Most offshore jurisdictions require that their own laws dictate the foreign claimant's rights and some jurisdictions will not enforce foreign judgments or will do so only after the case is heard or retried under local law.

By "importing the law", one seeks the protection of the laws of those jurisdictions which have aggressive asset protection legislation and alternately, by "exporting the assets", one seeks the comfort of jurisdictional severance and the greater security for assets provided by established offshore financial centers. For maximum flexibility, it may be advisable to provide for mobility in implementing the offshore arrangement by structuring the transaction so that the trust or other entity can later move from one jurisdiction to another, thus providing further protection from subsequent claimants.

A number of clauses and provisions may be drafted into the trust deed (i.e., trust agreement settling trust) to provide safeguards as well as peace of mind for the trust creator when the offshore asset protection trust does become foreign, and it is necessary for the creator to relinquish control including the Trust Protector Clause, Trust Enforcer Clause, Duress Clause, Migration or Flight Clause and the Emergency Trust Clause. There exist various special types of asset protection trusts including the Discretionary Trust, Purpose Trust, and the Rabbi Trust and the ever popular Integrated Estate Planning Trust.

STRUCTURE OF APTs

Generally, a single foreign trust owning as its sole asset all of the capital stock of an international corporation will be appropriate for most integrated estate planning and asset protection arrangements. The use of a private trust company places trusteeship in an entity established by the settlor, the shares of which are owned by the trust established for the sole purpose of holding the company's shares (there are no beneficiaries of such a "purpose" trust"), with the settlor serving as director of the private trust company without compromising the arrangement and affording the settlor the opportunity to exercise a higher degree of control over the trusteeship of the trust.

This ownership method is useful for control issues, limitation of liability, additional anonymity, facilitation of business transactions, ownership of assets in civil law jurisdictions which do not recognize the trust form of ownership, as well as for participation in foreign bank and mutual funds as well as other investments not available to U.S. individuals. Such a "drop-down" corporation is a foreign corporation that is created and wholly owned by the trust for the purpose of holding title to one or more assets. The settlor can be one of a permissible class of beneficiaries with the trustee of the foreign trust having complete discretion as to whom distributions of income would and would not be made and the trustee may be given the authority to remove at its discretion a beneficiary from the permissible class and to substitute new beneficiaries, including charitable beneficiaries.

DECOSIMO'S INTEGRATED ESTATE PLANNING TRUST (IEPT) is the emerging successor to traditional estate planning trusts traditionally funded with life insurance on grantors' lives, are now being effectively coupled with contemporary estate freezes that use family limited partnerships (FLPs) and limited liability companies (LLCs). After transferring appreciated assets to the FLPs and LLCs, interests may be valued by a qualified appraiser and then sold at discounted values (for lack of control and lack of marketability) via installment sales to defective (irrevocable) grantor trusts (DGTs). This effectively joins the mitigation of estate tax with an asset protection structure. It is understood that attorneys draft legal documents and CPA's are not to offer legal advice or guidance in structuring an integrated estate planning arrangement of a domestic or foreign nature.

DOMESTIC V. FOREIGN VENUES

Delaware, Nevada, Alaska, and Rhode Island, for example, have each enacted legislation for establishing asset protection trusts. While these statutes appear to offer substantial asset protection, especially against the future claims of creditors, none of these states can be as protective as an offshore jurisdiction for establishing trusts.

One of the key provisions of the new domestic venue law is that it permits and recognizes the validity of "self-settled" discretionary trusts, whereby a settlor can establish a trust, the assets of which are not reachable by the settlor's creditors, and still retain an interest in the trust (i.e., the ability to receive distributions at the discretion of the trustee). Nearly all other states have either statutory or case law that views such self-settled discretionary trusts as void with respect to creditors' claims for public policy reasons.

U.S. residents most often use offshore trust arrangements to protect asset and provide meaningful economic diversification via an internationally diversified investment portfolio. The inherent difficulty in accessing a foreign trust, both physically and legally, should influence a potential future claimant not to pursue an action, or at least incline the claimant to settle in ways more favorable to the defendant.

FORMATION & FUNDING

Foreign asset protection trusts are tax neutral, they are generally established to protect assets and not to save income or estate taxes. Income tax savings with a foreign trust that has a U.S. grantor and/or beneficiary, or a foreign grantor and a U.S. beneficiary, are no longer allowed. However, some strategies remain to accumulate earnings offshore and minimize the accumulation tax penalty that applies when earnings are repatriated.

A foreign asset protection trust is generally created as a domestic trust with the switch to a foreign mode being triggered by a threat from a creditor or a similar event that jeopardizes trust assets. When established, an asset protection trust is generally created as an irrevocable trust as opposed to a testamentary trust, even though the latter is permissible. If revocable, the trust does not exist as a separate entity but is deemed an extension of the creator.

The Isle of Man, Nevis, and the Cook Islands are three platforms from which to launch wholly owned corporations that hold settlor's transferred assets. We perform due diligence in selecting jurisdictions, trustee companies, and domestic and jurisdictions legal counsel; domestic legal counsel should be fully involved in planning such an arrangement from the outset.

SAFEGUARDS FOR APTs

The trustee has discretion to distribute income to named beneficiaries and to remove or add beneficiaries. The trust document can give the trustee several discrete/joint options. During the "no interest" term the settlor has no rights to principal or income. Therefore, claimants are excluded from reaching the trust's resources via the settlor. The "no interest" time frame can be tied to the occurrence of a predefined event or to a foreign jurisdiction's statute of limitations period for claimants. An event-triggered feature gives the settlor beneficiary status until an event happens. When it does, such as a claimant securing a judgment, a new class of beneficiaries is established and the settlor's beneficial interest moves to last place. An "abeyance period" extends the trustee powers to include holding the settlor's right to trust principal and income until such time as "danger" to trust assets passes.

Other trust safeguards include a protector clause and a migration flight clause. The former authorizes an individual or entity, referred to as a "protector," (the writers' recommend using one), to make key decisions or take key actions at specific times such as to change the proper law of the trust; to secure information about the trust; and to be named his or her own replacement if, for example, the trust creator has died. A migration or flight clause allows the trust to be removed by the trustee (redomiciliation) to another jurisdiction whose laws will make it more difficult for the creditor to succeed.

SPECIAL TYPES OF FOREIGN TRUSTS

For U.S. income tax purposes, integrated offshore arrangements are generally grantor trusts even though fully irrevocable for legal and transfer tax purposes. Two features, a discretionary trust and purpose trust, assist in providing guidance as to creator wishes. A discretionary trust gives the trustees broad discretion as concerns managing trust assets and distributing income and capital among beneficiaries and are typically accompanied by a creator's "letter of wishes". Appointment of a trust protector further limits the discretion of the trustees. The protector, generally having the power to remove a trustee, oversees the trustees' performance to ensure alignment with the trustor's desires. Purpose trusts have a purpose, not a beneficiary. They have an enforcer, in addition to a trustee, to make sure the trustee carries out the trust's practical use of IAPTs with IDITs.

Intentionally defective irrevocable trusts (IDITs) are designed to be defective – thus, the grantor is responsible for tax on income attributable to the trust. Lacking the "defective" element, the

irrevocable trust would be responsible for its own tax at compressed rates. IDITs provide two estate tax-saving planning techniques that use gifts and installment sales. First, the settlor pays the trust's income tax that the IDIT would otherwise have to pay; the settlor's tax payment is not treated as an additional gift to the IDIT for U.S. gift tax purposes. The intent is to maximize the IDIT's growth, by having its assets compound on a tax-free basis, while devouring the taxable estate to the appropriate level, before switching to nongrantor status, in order to stabilize the value of the settlor's estate.

ALTERNATIVE OFFSHORE IDIT

The difficulty with IDITs is determining the best way to turn off an activated grantor trust feature. The inherent flexibility allows the settlor the option of retaining sufficient assets within the estate to live out his/her life at a self-defined level of comfort. Choices exist for the settlor to circumvent having to pay income tax on income attributable to the IDIT classified as a grantor trust. One option is for the settlor to relinquish those powers initially given him that caused the IDIT to be defective; the relinquishment cancels the grantor trust classification for income tax purposes.

In turn, the trustee can "toggle the switch" and re-grant power to the settlor. This renders the IDIT defective for income tax purposes and turns on grantor trust status. Too frequent toggling between settlor and trustee can be perceived as too harmonious and increase the likelihood that a retained life estate tax inclusion issue will arise for the settlor under IRC Section 2036.

To avoid having trust assets excluded from the settlor's estate while retaining the IDIT's grantor trust status, the authors draw upon the three requirements found in IRC Section 679 for a trust to be classified as a grantor trust: (a) a U.S. citizen transfers property, (b) the transfer is to a foreign trust, and (c) there is a U.S. beneficiary.

When not acting in harmony, the grantor or trustee has two methods to exercise a power that results in the IDIT being simultaneously classified as a foreign and a grantor trust,without the appearance that settlor and trustee are working in harmony.

Integrated offshore IDITs go beyond traditional domestic FLP. IDITs can be structured in tandem with installment sales to a defective grantor trust. New approaches provide trustee or settlor

with the ability to toggle the IDIT from foreign to domestic trust status for U.S. tax purposes. Strategic non-tax reasons to switch the IDIT's status from domestic to foreign include business purposes such as asset protection and/or the circumvention of the rule against perpetuities