ANALYSIS OF OFF-SHORE TRUSTS AS A METHOD OF ASSET PROTECTION PLANNING; TAX CONSEQUENCES OF TRANSFERRING ASSETS "OFF-SHORE" BEFORE AND AFTER DEATH OF TRANSFEROR; RECENT CHANGES IN THE INTERNAL REVENUE CODE INVOLVING OFF-SHORE TRUSTS; COMPARISON OF TECHNIQUES FOR ASSET PROTECTION PLANNING

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1. Introduction.

   a. Trusts have been used extensively in asset protection planning. Trusts were initially created during the Crusades in order to protect a nobleman's assets during the time he was in the Holy Land. From an asset protection perspective, the utility of a trust as an asset protection device will turn on whether the trust is a "self-settled" trust or "non-self-settled" trust and whether the trust is an off-shore trust or U.S. situs trust.

   b. A "self-settled" trust established in the United States where the grantor is also a beneficiary of the trust will not, in general, receive the protections of any spendthrift rules of State law. See, for example, A.R.S. § 14-7705A.

   c. In contrast, a U.S. trust established by a third party will receive protections afforded by the spendthrift laws of the States. See, for example, A.R.S. § 14-7701A. and § 14-7702A.

   d. Off-shore trusts established in certain jurisdictions may have some of the same asset protection attributes as "non-self-settled" trusts established within the United States.

   e. Significant tax consequences can arise in connection with the formation, operation and distributions from off-shore trusts.

2. Spendthrift Rules.

   a. In 1990, Arizona enacted spendthrift rules relating to the transferability of interests in trusts and the enforcement of creditors' claims against trust beneficiaries' interests in trusts.

      (1) As a general, spendthrift clauses are valid under Arizona law. A.R.S. §§ 14-7701A. and 7702A.

      (2) Judgment creditors can only pursue the beneficiary of a trust after payment has been made to such beneficiary. If payment has not yet been made but is currently due, then the creditor can petition the Court for an order directing payment of the judgment directly by the Trustee. A.R.S. §§ 14-7701B. and 7702B.

      (3) Arizona law provides a special set of rules for so called "self-settled" trusts. A.R.S. § 14-7705. These trusts are trusts of which the settlor/ grantor is also the beneficiary.

      (4) Under the rules for "self-settled" trusts, the spendthrift clause is invalid against the settlor's creditors. A.R.S. § 14-7705A.

(5) The creditor protection generally available for trusts created by third parties does not apply in the case of certain types of creditor claims. A.R.S. § 14-7707. For example, claims for child support or spousal support may be made against a trust created by a third party. In addition, the claims of the United States or the State of Arizona may be satisfied from the corpus of the trust.

(6) From a planning perspective, any inheritance or gifts to a person who is concerned about creditor protection should be made to a spendthrift trust. The trust can include generation-skipping provisions subject to the limitations of the generation-skipping tax exemption. See, I.R.C. § 2601 et. seq.

(7) A spendthrift trust under Arizona law may provide that the beneficiary can act as his or her own trustee. A.R.S. § 14-7706A. Under A.R.S. § 14-7706B., spendthrift clauses are invalid if the "sole" beneficiary is also the "sole" trustee. Generally, a generation-skipping trust will have the current income beneficiary followed by future income beneficiaries. Accordingly, the beneficiary can serve as trustee of such a trust since he or she is not the "sole" beneficiary of the trust.

b. A discretionary trust is a trust in which the trustee has absolute discretion to distribute or withhold income and principal to the beneficiary. Typically, such trusts do not include any specific language directing that income or principal be used for a particular purpose. Generally, under Arizona law, a creditor of a beneficiary of a discretionary trust may not compel the trustee to pay an amount to or for the benefit of the beneficiary. A.R.S. § 14-7704. If a discretionary trust includes a spendthrift clause, then the beneficiary will have two defenses to claims of potential creditors.

3. Taxation of Trusts.

a. A trust, in general, is treated as a separate taxable entity under the Internal Revenue Code. However, if the grantor or beneficiary retains certain types of control over the trust, then under I.R.C. §§ 671-679, the grantor or beneficiary is treated as the owner of the trust assets.

(1) A trust's taxable income is computed similarly to that of individuals with certain modifications. I.R.C. § 641(b). The major modification is that a trust is allowed a deduction for distributions made to its beneficiaries. I.R.C. § 651(a) and I.R.C. § 661(a).

(2) Distributions from a trust to a beneficiary generally are includable in the beneficiary's gross income to the extent of the "distributable net income" of the trust. I.R.C. § 652(a) and I.R.C. § 662(a). "Distributable net income" is taxable income increased by tax exempt income and computed without regard

to personal exemptions, distribution deductions and various other items. I.R.C. § 643(a).

(3) Distributions to trust beneficiaries out of previously accumulated income are taxed to the beneficiaries under a "throw-back rule." I.R.C. § 667. The effect of the "throw-back" rule is to impose an additional tax on the distribution of previously accumulated income in the year of distribution at the beneficiary's average tax rate for the five years prior to the distribution.

(4) Under the grantor trust rules, the grantor of a trust will continue to be taxed as the owner of the trust if he retains certain powers or rights. I.R.C. § 671. For example, if the grantor retains the right to reacquire the trust corpus by substituting other property with equivalent value, he will be treated as the owner of those assets. I.R.C. § 675(4)(C).

b. Foreign trusts are subject to separate rules with respect to U.S. taxation.

(1) A foreign situs trust is not subject to U.S. income taxation on its income which is not derived from U.S. sources or which is not effectively connected with the conduct of a trade or business within the U.S. I.R.C. § 7701(a)(31).

(2) Distributions from foreign situs trusts (which are not grantor trusts) are taxed similarly to distributions from U.S. situs trusts. Thus, the beneficiary is subject to tax on distributions from the trust which equal the trust's distributable net income. Distributions in excess of distributable net income are treated as accumulation distributions and subject to tax under the "throw-back" rules. In addition, Under I.R.C. § 668, interest is charged on accumulation distributions. The interest is computed under prior law at a fixed annual rate of 6% with no compounding.

(3) Under prior law, the grantor trust rules were also applied to foreign trusts. In general, two types of foreign grantor trusts exist: "inbound trusts" and "outbound trusts." In the case of an "inbound trust," a foreign person was the grantor and the trust was established so that it was a grantor trust with all items of income being taxed to the foreigner. In the case of an "outbound trust," a U.S. person was the grantor and all items of income were taxed to the U.S. person.

c. A U.S. person will be subject to a 35% excise tax on the transfer of assets to a foreign trust (computed on the appreciation in the transferred assets) where the trust does <u>not</u> constitute a grantor trust. I.R.C. § 1491. The tax is not applied if the taxpayer sells the assets to the foreign trust and pays tax on the gain.

d. In 1996, Congress made substantial changes in the rules relating to foreign trusts. Sections 1901 through 1907 of the Small Business Job Protection Act. The changes relate both to foreign "inbound trusts" and foreign "outbound trusts." Congress perceived a number of abuses with the treatment of foreign trusts under U.S. law.

(1) "Inbound" grantor trusts were being used to completely avoid income taxation on the earnings of foreign trusts. Under the grantor trust rules, a foreign person was treated as the grantor of the "inbound" trust. The foreign person was treated as the owner and subjected to tax on all earnings of the trust, even though the earnings were being distributed to a U.S. beneficiary. However, under U.S. tax law, the foreign person (the grantor) was not subject to tax on earnings of the trust unless the income was derived from U.S. sources or was effectively connected with a U.S. trade or business. Thus, the trust income was never taxed under the U.S. tax laws. Congress changed the law relating to grantor trusts to provide that a foreign person would not, in general, be treated as the grantor of a trust. I.R.C. §§ 671-679. See I.R.C. § 672(f).

(2) In the case of "outbound" U.S. trusts, certain abuses were also occurring. In particular, the § 1491 excise tax relating to "outbound" trusts, did not apply in connection with the sale of assets from a U.S. person to a non-grantor foreign trust. Many sales were structured as installment sales whereby the off-shore trust gave a promissory note or promised to pay an annuity back to the U.S. person in exchange for the assets transferred off-shore. The § 1491 excise tax was avoided because a taxable transfer avoids that tax. The new legislation amended these rules so that promissory notes would be disregarded in connection with determining whether a trust had received assets from a U.S. person in a non-taxable disposition. I.R.C. § 679(a)(3).

(3) In the case of a foreign trust which is not a grantor trust, prior law had a provided a 6% simple interest, non-compounded, rate be applied to the tax arising under the "throw-back rules." The purpose of the interest charge was to compensate the government for the deferral given to the taxpayer on the payment of the tax on the accumulated income. The new law changed the interest rate so that the interest rate is that generally applicable to underpayment of tax. I.R.C. § 668.

(4) For non-grantor foreign trusts, only distributions to a beneficiary were subjected to income tax under U.S. tax law. Many trusts structured payments to beneficiaries as "loans" which were not subjected to U.S. income tax. The new tax law sought to avoid this abuse by treating such loans as distributions to the beneficiaries. I.R.C. § 643(i). The House Ways & Means Committee report to the legislation, however, instructs the I.R.S. to draft regulations which carve out an arms length loan exception to these rules.

(5) The situs of a trust under prior law was determined by a "facts and circumstances" test. Under the new provision, a two part objective test is established for determining whether a trust is foreign or domestic. Both tests must be satisfied in order for a trust to be treated as a domestic trust. Under the first test, in order for a trust to be treated as a domestic trust, a U.S. court must be able to exercise primary supervision over the administration of the trust. Under the second part of the test, a trust is treated as domestic if one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. I.R.C. § 7701(a)(30)(E).

(6) The new law also has rules which reclassify as a foreign trust or a domestic trust in certain instances. For example, if a non-resident alien individual transfers property to a foreign trust and within five years becomes a U.S. resident, then that trust will be treated as a U.S. grantor trust and not as a foreign trust. I.R.C. § 679(a)(4). Similarly, if a U.S. person transfers assets to a trust which is initially a domestic trust and subsequently becomes a foreign trust, that conversion of the trust from domestic to foreign will trigger tax consequences to the grantor under § 1491. Those tax consequences include a tax imposed the appreciation in any capital assets held in the trust.

(7) Congress also perceived a lack of compliance under prior law with the reporting requirements for foreign situs trusts in tax havens. Under the changes made by the 1996 Act, extensive reporting requirements are imposed upon the grantor and others relating to foreign situs trusts. I.R.C. § 6048. The reporting requirements apply as follows:

   (a) upon the creation of the foreign situs trust by a U.S. person;

   (b) upon the transfer of assets to the foreign situs trust; and

   (c) upon the death of a U.S. citizen or resident alien if any portion of the foreign trust is included in his or her gross estate.

(8) In addition, if a person is treated as the owner of any portion of a foreign trust, he or she is required to file an annual report providing detailed information with respect to the trust activities. I.R.C. § 6048(b).

(9) Finally, any U.S. person who receives a distribution from a foreign situs trust is required to file a notice to report the name of the trust to the I.R.S., together with additional information. I.R.C. § 6048(c). In order to enforce the new reporting requirements, new substantial penalties are imposed upon the person responsible for filing the information returns. I.R.C. § 6677.

e. The recent changes in the treatment of foreign trusts did not, however, affect the ability of U.S. taxpayers to take advantage of § 663(a)(1). Under that Section, gifts or bequests of a specific sum of money which are paid all at once or in not more than three installments do not carry out distributable net income. Accordingly, those distributions are not subject to U.S. income tax in the hands of the recipient. Distributions from a foreign trust which are made in compliance with the rules of § 663(a)(1) will not be subject to income tax in the hands of the recipient. Furthermore, if the foreign trust is set up in a tax haven country, the income from the foreign trust (as long as it is not a Grantor Trust) will not be subject to U.S. income taxation.

4. Off-shore Trusts.

Off-shore trusts are used for income tax planning, as well as asset protection planning.

a. Generally, on-shore trusts do not provide the asset protection area where the grantor/settlor of the trust is also a beneficiary of the trust. In these circumstances, the spendthrift statutes and other protective provisions dealing with discretionary trusts will not be available to protect the assets from the creditors of the grantor/settlor.

b. An off-shore trust, however, is generally established in a jurisdiction which has statutes that allow the grantor/settlor the protection of the spendthrift laws of that jurisdiction, as well as the protection afforded to a beneficiary of a protective or "discretionary" trust.

c. An important aspect of off-shore trusts is the local law dealing with fraudulent conveyances. The original common law fraudulent conveyance statute (the Statute of Elizabeth) has served as the basis for the fraudulent conveyance statutes in the United States, as well as other English common law jurisdictions. However, many foreign jurisdictions have enacted their own fraudulent conveyance statutes.

d. Typically, an off-shore fraudulent conveyance statute should have a statute of limitations which precludes the commencement of proceedings challenging the conveyance to the trust after the lapse of a period of time. Second, the off-shore jurisdiction should require a de novo trial on the substantive issue of liability of the beneficiary. In other words, the notion of comity is not recognized in the off-shore jurisdiction and a U.S. creditor will only be able to obtain a judgment after proving in the off-shore jurisdiction (under the laws of the off-shore jurisdiction) that the liability exists. Third, the off-shore jurisdiction should specifically allow the settlor/beneficiary control over the trust by way of the retention of certain powers over the trust, including the power to revoke or amend the trust at a subsequent date.

e. A number of jurisdictions are used for off-shore trusts. The most prominent jurisdictions are as follows:

(1) *The Cook Islands.* The Cook Islands are in the middle of the Pacific Ocean. The major reason for using the Cook Islands as an off-shore trust situs is recent legislation which provides a two year statute of limitations on fraudulent transfers and requires a proof of fraudulent transfer "beyond reasonable doubt." The Cook Island statutes also allow the grantor/settlor to retain substantial powers over the trust corpus.

(2) *The Cayman Islands.* The Cayman Islands are approximately 500 miles south of Miami, Florida, in the Caribbean. The Cayman Islands have a six year statute of limitations on fraudulent dispositions and fraudulent transfers are only set aside to the extent necessary to satisfy the claim of the creditor brining the action.

(3) *Isle of Mann.* The Isle of Mann is located between Scotland and Ireland in the Irish Sea. The Isle of Mann uses English common law in connection with fraudulent conveyances. In connection with fraudulent conveyances, the old Statute of Elizabeth and the common law are applicable. However, under Article 6 of "The Hague Convention on the Law Applicable to Trusts and on Their Recognition," a trust "shall be governed by the law chosen by the settlor." This provision has been used to establish trusts in the Isle of Mann, which are governed by laws of a jurisdiction with more favorable asset protection laws, such as the Cook Islands.

(4) *The Bahamas.* The Bahamas are approximately 60 miles east of Palm Beach, Florida, and extend southward from there. In 1991, the Bahamas enacted a fraudulent conveyance statute which provides for a two year statute of limitations on the commencement of proceedings and places the burden of establishing the settlor's fraudulent intent on the creditor. These provisions make the Bahamas an attractive place for off-shore trusts.

(5) *The Channel Islands.* The Channel Islands are off the coast of France and include the islands of Jersey and Gurnsey. Both islands specifically enacted trust legislation in the 1980s and the 1990s. However, neither island has a statutory provision governing fraudulent conveyances. Instead, English common law (with its tradition for setting aside dispositions made in fraud of creditors) is applied in both Jersey and Gurnsey.

5. Planning with Off-Shore Trusts.

a. As a planning consideration, off-shore trusts are used in two ways described below:

(1) Off-shore trusts can directly hold U.S. assets. Thus, the assets are removed from the jurisdiction of the U.S. courts since the assets are physically located off-shore.

(2) A second way of utilizing off-shore trusts is to have the off-shore trust act as a limited partner in a family limited partnership. The assets remain on-shore in the name of the limited partnership. The general partner of the limited partnership will either be the client or an entity controlled by the client. The client will be able to directly invest the assets in U.S. activities without the need to run every transaction or attempted investment through an off-shore trustee.

b. Typical clauses in an off-shore trust protect the client/settlor are as follows:

(1) A "duress" provision typically will empower one or more persons (other than the trustee) to veto an act of the trustee, to remove the trustee and replace the trustee with another person. However, the duress clause will provide that the trustee is to ignore any advice, order or instruction which is given under duress by the person granted such power under the instrument. For example, if the client/settlor is directed, under duress, by a U.S. court to instruct the trustee to bring the assets back to the United States, then the duress clause will instruct the trustee to ignore these instructions made by the settlor.

(2) A "flight" provision empowers the trustee to change the situs of the trust administration or governing law and to transfer asset to effectuate such changes. These types of provisions usually are put into trusts in order to take into account issues such as civil unrest or an unfavorable change in the tax law or political climate of the off-shore jurisdiction of the trust.

(3) A "protector" provision. A "trust protector" is a person who usually has certain powers over the trust, but who is not the trustee. Typically, the trust protector has a veto power over the trustee's decisions and will have the ability to remove and replace the trustee.

(4) The trust will also be a "discretionary" trust so that no amounts are required to be paid to a particular beneficiary but, instead, will be distributed in the sole discretion of the trustee among a group of beneficiaries. This discretionary provision adds another layer of protection in connection with the transfer of assets to the off-shore trust.

6. Comparison of Asset Protection Techniques.

a. The best asset protection planning involves the use of several of the tools. In particular, the use of family limited partnerships, off-shore trusts and third party created trusts will provide adequate asset protection in most instances.

b. In attempting to create an asset protection plan for a client, tax considerations (estate tax, gift tax and income tax) must be taken into account. A properly developed asset protection plan will also generate significant estate tax and income tax savings to the client and the client's heirs. Furthermore, the existence of substantial non-asset protection (or creditor protection) motives for creating the plan should give further substance to the plan and cause difficulties for third parties who seek to challenge that plan.

c. The following planning issues should be taken into account in creating the asset protection mechanisms:

(1) Any inheritance or gifts received by the client should be placed in spendthrift trusts. Under the Arizona spendthrift laws, these assets will be protected from the beneficiaries' creditors.

(2) New business ventures which appear to have substantial potential for growth should be owned by a limited liability company which is, in turn, owned by the spendthrift trust created by the client's parents. For example, if the client plans on investing in a new real estate venture, the best method of setting up the investment is to have the client's parents set up a spendthrift trust for the benefit of the client. The trust will, in turn, invest in a limited liability company. That limited liability company will be able to borrow money from the client in order to undertake the real estate project. The limited liability company will serve as protection to the trust's other assets in the event that the project proves to be unsuccessful.

The foregoing structure of using a spendthrift trust created by the client's parents and a limited liability company to hold assets will protect the initial investment and all future growth from the creditors of the client. The principal and accrued income in the trust will also avoid estate tax on the beneficiaries' death. However, the parent must allocate his or her GST exemption to the trust to avoid taxation at the death of the child/beneficiary.

d. Family limited partnerships afford both estate planning opportunities as well as asset protection. The asset protection with respect to charging orders is highlighted by the fact that the Arizona limited liability company statute allows remedies to creditors in addition to a charging order. However, the limited partnership statute only allows a charging order to be entered against the creditor/partner and does not allow any other relief to the creditor.

In addition to asset protection, "discounting" of the partnership interests will be permitted under current federal estate and gift tax laws. Thus, the motive for setting up a family limited partnership is not solely asset protection. The estate planning motives should create a defense to a creditor's argument that the limited partnership was established in order to hinder or delay creditors.

e. Off-shore trusts may either hold assets directly or may be a limited partner in a family limited partnership. The off-shore trusts have significant tax savings after the death of the grantor/settlor. In particular, § 663(a)(1) allows distributions from the off-shore trust to the U.S. beneficiaries to be made income tax free. If the trust is established in a tax haven jurisdiction, then none o the trust income would be subject to U.S. tax or to foreign tax.

f. The establishment of a marital trust (a QTIP trust) for the benefit of the grantor/client's spouse should also provide asset protection since the spouse of the client will be giving up marital rights in exchange for the client's creation of a marital trust. On the other hand, if the client and his or her spouse are divorced, then the client will loose any ability to have access to the trust assets.