

## **THE INTERNATIONAL ASSET PROTECTION TRUST**

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The goal of this paper is for the reader to see the importance for the settler (our U.S. securities or other highly appreciated asset type of client) to protect his assets from his future, potential creditors. He should use an offshore asset protection trust for this purpose. This trust will include a spendthrift (anti-alienation) clause and he will remain a beneficiary to use the monies from these securities during his lifetime and those of his heirs.

Because it is much more difficult to access the assets of an offshore trust than a domestic trust, both physically and legally, the effectiveness stems from persuading the potential creditor to not pursue the action or at least settle. Remember always that, "Settlement is an art".

Perhaps we tend to feel that our client will not need asset protection as s/he is an honest person. No doubt s/he is. However, s/he may have a lifestyle based on their projected earnings on their securities and all of a sudden the market crashes and s/he cannot wind down their lifestyle in time to meet his current obligations.

## **THE ROLE AND DUTIES OF THE PRACTITIONER**

Before we can recommend an appropriate set of structures for our U.S. client, we must gather sufficient information from him:

1. We must investigate one's situation as follows:
  - A. We must fully explore one's financial situation.
  - B. We must obtain an affidavit of solvency so we are not victims of a fraudulent transfer act.
  - C. We must examine one's financial statement.
  - D. We must see if this plan will hinder any present or potential subsequent creditor.
  - E. We examine all of one's debts, liabilities and obligations in detail and itemize all risks, exposures, guarantees and contingent liabilities. Also, we gather information about one's historic method of doing business and his general reputation among business associates and past creditors.
  - F. We investigate to eliminate suspect as to criminal activity and money laundering and if there is any doubt, then we refuse to represent this potential client.. We might seek the advice of co-counsel with expertise in creditors' rights and fraudulent transfers when appropriate.
2. We then explore the client's motives.
  - A. ECONOMIC OR INVESTMENT ISSUES:
    1. Economic diversification: We might engage a portfolio manager to oversee the international investment component of one's assets to reduce economic risk and increase the potential portfolio return. This advisor will have a decided advantage over U.S. money managers in making foreign investment decisions for the client.

Further, the arrangement helps to ensure that these assets are coordinated with a comprehensive estate plan.

2. There can be participation in investments not otherwise available to the investor. Certain foreign mutual funds and other investment vehicles are not available directly to a U.S. investor, but are available to foreign trusts and foreign corporations, even if owned by, controlled by or benefiting a U.S. investor.
3. Pre-planning in anticipation of currency controls.

B. TAX ON ESTATE PLANNING ISSUES:

1. Tax Transfer Planning
2. Income Tax Planning

C. PERSONAL OR FAMILY ISSUES

1. An offshore trust will establish a new set of financial and legal relationships and will expedite further movement of the U.S. investor wealth in the event one may wish to re-locate in the future.
2. Marital property planning (establishing a vehicle to receive partitioned community property, spousal gifts and to establish QTIP trusts).

NOTE: Careful exploration may uncover multiple benefits of an offshore trust and influence the way the plan is ultimately structured.

## **METHODS OF ATTACK**

No matter what the circumstances, the creditor must first obtain a judgment against our U.S. investor in a U.S. court. Especially if there are fraudulent conveyance issues. In this case, the U.S. investor is an honest person and a fraudulent conveyance is not an issue. However, if he doesn't create this mechanism now, s/he may find that their life circumstances changes later when it will be too late to form the offshore entity without it being a fraudulent transfer. After a judgment is obtained, the creditor may bring a suit against our client in the jurisdiction where the trustee is domiciled on where the trust assets are located.

There are, in actuality, only three arguments that the creditor can claim:

1. Asset protection features of the trust tend to offer public policy in the jurisdiction where the post judgment action is brought. Therefore, the governing law of the trust could be ignored, although it usually isn't.
2. The settler's transfer was fraudulent and should be set aside, which is clearly not the case here as our client plans to have us form the trust expeditiously.
3. The offshore trust is a "sham" trust or is the alter ego of the settler and because the settler never really parted with dominion and control over the trust assets, the courts should disregard the trust structure. There are a number of specific methods to address the "control issues" (protectorship, letters of wishes, advisory committees, co-trusteeships, etc.)

## **THERE ARE TWO TYPES OF CAPITAL ASSET STRUCTURES**

There are two ways to shield assets into an offshore asset protection trust.

### 1. EXPORT THE ASSETS

All of the assets are placed in a foreign jurisdiction with a foreign structure and a foreign trustee and all ties with the U.S. federal and State federal and state judicial systems are severed. It is difficult for the creditor to travel to this jurisdiction as most of them don't recognize U.S. judgments.

Moreover, in some jurisdictions, a plaintiff is required to post ten to fifteen percent of the amount claimed as a condition to filing the lawsuit.

### 2. IMPORT THE LAW

One selects a favorite jurisdiction in conjunction with a U.S. Family Limited Partnership or other domestic legal entity that holds some of the U.S. investors of the assets.

- A. The U.S. investor conveys all or part of his interests or shares to the foreign trustee. The goal is that the barricades of the aggressive foreign law applicable to this law will have been brought "on shore" to the U.S. in a way as to defeat the creditor.
- B. When one imports the foreign law, it may still be possible to export the assets at a later time (by virtue of a liquidation right provided to the trustee/limited partner in the partnership agreement. (There is always the risk that the assets can be frozen here, that the timing of moving constitutes a fraudulent transfer or the immovability of the assets.

C. In this instance, securities are movable and the U.S. investor is not vulnerable to a fraudulent transfer presently. However, timing is always critical and we do live in an imperfect world meaning that the circumstances may in the unforeseen future create a fraudulent transfer situation.

3. ANTI-DURESS CLAUSE: One should insert an “anti-duress” or “anti-alienation” provision which provides that if the trust receives an enforcement order from a U.S. court, they are mandated to ignore the directions from any person who is acting under the jurisdiction of the court. Moreover, it is best that the trustee be mandated to transfer the assets to another jurisdiction.

4. LOCATION OF TRUST ASSETS:

It is best to have the trust assets in jurisdictions other than the trust situs. A creditor can find that a lawsuit filed in the trust situs jurisdiction may be ineffective if the trust assets are not located there. However, this will be ineffective with careless planning. In other words, stay away from a custodial arrangement with a branch of a U.S. bank abroad which may inadvertently expose trust assets to the jurisdiction of the U.S. courts.

### **TAX TREATMENT OF A TYPICAL ASSET PROTECTION TRUST**

Usually, an irrevocable discretionary trust is established by a U.S. citizen or resident settler in a foreign jurisdiction whose law recognizes “self-settled” spendthrift trusts (for the benefit of the settler) with a trustee who will have the authority to make most of the

substantial decisions. The beneficiaries of the trust will include beneficiaries who are citizens or residents in the U.S., members of the settler's family, including the settler. Because the trust is so assigned so that the U.S. court will exercise primary jurisdiction over the administration of the trust, and because no U.S. trustees have any authority to control or substantiate decisions of the trust, it is considered a "foreign trust" for U.S. tax purposes. Because it will have U.S. beneficiaries, it is treated as a grantor trust and all income is taxed to the grantor<sup>1</sup>.

There is no tax angle when a U.S. citizen or resident establishes a typical asset protection trust. Its income is included in the settler's taxable income and its assets are included in the settler's gross estate. However, the assets held in the trust at the time of his death will receive a tax-free step up in basis.

### **USE OF AN INTERNATIONAL BUSINESS COMPANY (IBC) WITH AN OFFSHORE TRUST**

An IBC is formed by a nonresident of a favorable non taxable jurisdiction. The trustee of an offshore asset protection trust may transfer the trust assets to the IBC in exchange for its stock. The transfer of appreciated assets by the trustee of an offshore trust to an IBC is subject to a capital gain under I.R.C. #467, unless the IBC is engaged in a trade or business.<sup>2</sup> The IBC then generally contracts with a foreign bank or other investment

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<sup>1</sup> IRC #679

<sup>2</sup> See Osborne, Asset Protection: Domestic and International Law and Tactics, #23.18 (Clark, Boardman & Callaghan, 1995).

management firm to manage the assets. A nominee arrangement between offshore trusts and IBC's may avoid the income tax consequences of I.R.C. #367.<sup>3</sup>

The use of IBC's with offshore trusts serves four primary purposes.

1. Corporations are more commonly recognized investment vehicles by civil law countries.
2. There is often a concern about leaving assets in jurisdictions with favorable asset protection laws. The use of an IBC makes it easier to transfer substantially all of the trust assets to a custodial bank or other custodian in a stronger jurisdiction,.
3. If the trustee of the offshore trust invests in foreign securities, the settler may be subject to foreign death taxes. By forming an IBC, the trustee, and therefore the settler of an asset protection trust, is deemed to own shares of stock in the IBC, not the securities of companies purchased in other jurisdictions, thereby avoiding foreign death taxes. It is questionable whether a nominee IBC formed by the trustee of an asset protection trust that acquires foreign securities avoids foreign death taxes.
4. Foreign funds and foreign securities can be sold without registering with the U.S. Securities and Exchange Commission under the Regulation S exemption of the 1933 Securities Act. Banks are normally more comfortable contracting with an IBC than the trustee<sup>4</sup>
5. There are 4 major potential tax problems with the IBC.
  - A. Capital losses in the IBC are not deductible until the IBC is liquidated.

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<sup>3</sup> I.R.C. #367(d).

<sup>4</sup> See Spitz, Barry, International Tax Havens Guide, Offshore Tax Strategies, #18.04, Aspen Publishers, Inc. (2002).

- B. The IBC converts all capital gains into ordinary income (39.6% tax vs. 20% tax).
- C. Double taxation results from distributions of dividend income from the U.S. sources (stock in U.S. companies) through the offshore trust to the U.S. beneficiary (or to a direct owner of the IBC); and
- D. There is no step-up in basis at the death of the U.S. shareholder of an IBC not engaged in a trade or business (i.e. it owns passive investment assets).

6. Therefore, the foreign trustee of the offshore trust should form a foreign LLC.

None of the four disadvantages as stated above apply. However, only a corporation formed outside the country in which the stock is purchased avoids foreign death taxes. Thus, use of the LLC is only a partial answer. In the U.S., for most entities (foreign or domestic), U.S. persons are allowed to check-the-box (under Treasury Regulations) on IRS Form 8832 to treat an entity as either a corporation or a partnership (or disregarded entity for a one person LLC) for tax purposes. However, the U.S. Treasury Regulations list entities formed under corporate laws of stated jurisdictions as per se corporations. What this means is that if an IBC is formed under any of these particular jurisdictions, the IBC is treated as a corporation for tax purposes, with no election available under the check-the-box. In order to properly plan, the IBC must be formed in a foreign jurisdiction that is not treated under U.S. regulations as a per se corporation for tax purposes. Thus, an IBC, for legal purposes, can be formed, but the check-the-box form can be filed with the IRS to treat this organization as a partnership or disregarded entity for tax purposes. A disregarded entity is a flow-through entity for tax purposes, meaning the owner and not the entity is taxed. This results in treating the entity as a corporation

for asset protection purposes and as a flow through entity for tax purposes. With a legal (no tax) existing IBC, inheritance taxes in a foreign country, such as the U.K. are avoided. However, for tax purposes (not legal), the IBC is treated as a disregarded entity, avoiding the negative tax aspects of an IBC stated above.<sup>5</sup>

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<sup>5</sup> *Ibid*