
CHAPTER I

Establishing and Drafting Offshore Asset Protection Trusts

GIDEON ROTHSCHILD

Two vital considerations in creating an offshore asset protection trust are selecting the most favorable jurisdiction in which to establish the trust and drafting the trust instrument to include all necessary and desirable provisions.

Offshore jurisdictions have been favored for decades by foreigners to escape forced heirship provisions in their home countries, to avoid hostile government seizure, or to obtain favorable tax benefits. More recently, several jurisdictions have enacted legislation intended to protect trust assets from the beneficiary's creditors. These offshore "havens" have developed a financial services industry that caters to these needs by crafting laws that make it attractive to form corporations, trusts, or other entities for such purposes.

Some jurisdictions have adopted trust (or foundation) laws that are more extensive than others. The first jurisdiction to enact such legislation was the Cook Islands (in the South Pacific) when it passed the International Trusts Amendment Act in 1989. As of 2018, at least twenty jurisdictions have enacted such legislation to encourage the use of trusts to protect assets from creditors.¹ The planner must select the jurisdiction in which to establish the trust by analyzing numerous factors, including the jurisdiction's legal system and specific trust law, its political and economic stability, tax laws, availability of professional services, presence of modern telecommunications facilities, and existence or lack of language barriers.

Why Use an Offshore Trust?

To understand why such offshore trusts have become popular, we need only look at the litigious society in which we live and the uncertainties

to which an individual is subjected by the domestic legal system (with its result-oriented judges). Although asset protection can take different forms (e.g., family partnerships, limited liability companies, or spend-thrift trusts), the objective, in all instances, is to create a level playing field for negotiating with a potential future creditor. The ethical planner will not assist a client who intends to engage in a fraudulent conveyance, regardless of the vehicle used. But there is no restriction on a client's ability to transfer assets to avoid future unknown creditors.²

In evaluating the appropriateness of using a foreign trust, the advisor must merely look to other common applications of foreign or nondomiciliary law. The most common analogy may be the use of Delaware law for corporate purposes even though no corporate activity is to be conducted in Delaware. Another example is the increased use of generation-skipping trusts established under South Dakota law to avoid state income taxes and the rule against perpetuities.³

By using offshore trusts, clients can obtain the necessary leverage to resolve disputes on more favorable terms than otherwise would be available under more traditional forms of planning. The true test of whether creditors can reach the assets of a properly established foreign trust occurs at the negotiating table. When a creditor realizes that the debtor has transferred her assets to an offshore trust, governed under laws that provide, in part, for nonrecognition of U.S. judgments, secrecy, and a set of almost insurmountable roadblocks, the probable result is a quick, cost-effective settlement in the defendant's favor.

Offshore trusts created by U.S. residents are not intended to avoid income or estate taxes. A U.S. person who establishes a foreign trust is subject to the grantor trust rules if any beneficiary is a U.S. person.⁴ Such trusts may also be deemed grantor trusts by virtue of certain retained powers or interests.⁵ Furthermore, existing reporting requirements mandate filing returns upon the creation of a foreign trust or the transfer of assets to such a trust.⁶ The advisor should ascertain that the client's intentions for creating a trust are not tax motivated because §§ 7206 and 7212 may provide grounds for imposing criminal liability on one who assists a taxpayer in avoiding the tax collection efforts of the Service.⁷

Choosing a Jurisdiction

In selecting a jurisdiction, the practitioner must understand that asset protection planning is not dependent on secrecy laws. The most effective plan takes into account the possibility that an aggrieved creditor will take all steps necessary to pursue a debtor, so the plan must withstand challenge in the forum selected. Therefore, the choice of jurisdiction for the trust is most critical.

Components of APT Legislation

In its most basic form, asset protection trust (APT) legislation has three major components. The first is that the offshore jurisdiction will not recognize foreign judgments. Consequently, to succeed against the trust, the opponent must commence an action anew in the foreign courts.

The second desirable component in trust legislation involves the extent of its fraudulent conveyance provisions. The starting point in this analysis is the Statute of Elizabeth, enacted in England in 1571. This statute still forms the basis of fraudulent conveyance law in England and the Commonwealth and is the forerunner of our Uniform Fraudulent Transfer Act and Uniform Fraudulent Conveyance Act. This statute is intended to protect all creditors by declaring void any conveyance made with the purpose or intent of hindering or defrauding creditors. Because a creditor seeking to enforce a judgment offshore (where a trust's assets are situated) will attempt to set aside a transfer to the trust on fraudulent conveyance grounds, it is imperative that the chosen jurisdiction has expressly overridden the Statute of Elizabeth.

Although eight of the APT jurisdictions have enacted specific overriding statutes,⁸ these provisions do not sanction or encourage fraudulent conveyances. Importantly, the desire to maintain credibility as a lawful society weighs heavily on these jurisdictions, and accordingly, they generally require assurances that the trust settlor does not intend to avoid legitimate creditors or engage in unlawful activities.

The third component of APT legislation is a provision that expressly permits the settlor to retain certain powers and benefits. This eliminates any challenge against the trust based on the settlor's retained interest. Some jurisdictions allow the settlor to be a discretionary beneficiary; to revoke or amend the trust; to remove, appoint, or direct a trustee; or to retain a power of appointment over the trust property.

Other Considerations

In addition to selecting an appropriate jurisdiction in which to register the trust, the advisor must draft the trust to enable the trustee to effectively take control over the trust assets to the exclusion of any judgment creditors of the settlor. There currently appears to be an attempt by some planners (including nonattorneys) to "sell" APTs as if they were commodities, in much the same fashion as planners have done with revocable living trusts. Offshore trust companies typically make available trust forms that are devoid of any domestic trust considerations (i.e., tax planning) or refined aspects necessary for the trust to rebuff a creditor successfully. These forms are not intended to be used without extensive modifications by the client's counsel, who should be experienced in such matters. These

trusts are complex documents and should not be implemented without analyzing all the issues.

Furthermore, a practitioner must carefully evaluate the client's financial condition to avoid possible ethical, civil, or criminal liability to the client and the practitioner. When a client intends to hinder existing creditors, asset protection planning not only is controversial but also may lead to adverse civil or criminal exposure for everyone involved. Clients engaging in such planning with the hope of hiding assets from creditors will probably be unsuccessful both at home and in the offshore jurisdiction.

Although a particular jurisdiction's trust laws may be among the most favorable, the client may wish to have his assets maintained and managed in a jurisdiction that is more established as a financial center, such as Switzerland. The client also may want to use a foreign corporation that could be administered by corporate officers chosen by the client. While such multiple entities result in additional cost and complexity, they offer flexibility and control and create further barriers to a creditor.

A planner desiring to create the optimum asset protection structure must be aware of the rights of litigants and the discovery procedures available to a judgment creditor. For instance, a trust may be established in a jurisdiction that prohibits disclosure of information. But if the client is compelled to disclose tax return information, copies of the trust document, and other information, a creditor may be able to determine the trust's situs and location of its assets. Despite this discovery, if the trust is properly structured, a foreign trustee could not be compelled to release assets to the creditor and the client could not be compelled to retransfer the assets since he does not have the power to do so. It therefore becomes vital to protect the foreign trustee from any enforcement action in the offshore jurisdiction. This can be accomplished through legislation. For example, several jurisdictions provide by statute that foreign judgments will not be recognized.⁹ It is also important to avoid using a trustee with a branch or an affiliated entity in the United States that could make it subject to the U.S. court's jurisdiction.

Statutes of Specific Foreign Jurisdictions

Many offshore jurisdictions have adopted legislation to obtain a piece of the APT pie, but considerable differences still remain among jurisdictions. For example, while most of these jurisdictions have overridden the Statute of Elizabeth, Belize and Cyprus have not.

Another critical provision to look for is the period within which a creditor may bring a claim of fraudulent conveyance. The Cook Islands deem a transfer not to be fraudulent if made more than two years after the creditor's cause of action accrued, and Cyprus, Nevis, the Bahamas,

and Cook Islands require that an action must be commenced within two years of the transfer of assets to the trust. In contrast, the Cayman Islands and Bermuda have a six-year limitations period (from the date of the transfer), while Belize, Gibraltar, and Turks and Caicos do not stipulate any limitations period, provided the transfer to the APT does not render the settlor insolvent. Furthermore, the Cook Islands, Labuan, Mauritius, Nevis, St. Vincent, and Seychelles require a creditor to prove *beyond a reasonable doubt* that the trust was established with the intent to defraud that creditor.

Other provisions found in the Cook Island statutes (which the author considers the most comprehensive) include the ability of the settlor to retain the power to amend or revoke the trust; dispose of trust property; remove, appoint, or direct the trustee; and remain a beneficiary, either alone or with others. The statutes also provide that if a transfer is deemed fraudulent, that fact does not void the entire trust; it makes only the property that is deemed fraudulently transferred available to satisfy the creditor's claim.

Nevis, which adopted trust legislation that resembles the Cook Islands statutes, requires a creditor to deposit a \$25,000 bond before bringing an action against any trust property.¹⁰ Combined with the English rule that requires the losing party to pay the other's legal fees and prohibits attorneys from working on a contingent fee basis, these laws can chill a plaintiff's desire to proceed further with litigation not only offshore but also in the United States.

Another consideration that planners should take into account is the effect of the settlor's bankruptcy. In the Bahamas, for instance, if the settlor becomes bankrupt within two years of a transfer, that transfer is void as against the trustee in bankruptcy.¹¹ On the other hand, the law of the Cook Islands (which is one of the few common law jurisdictions without a bankruptcy statute) provides that the settlor's bankruptcy does not make a transfer to a trust void unless the transfer is fraudulent under the normal rules.

Drafting Considerations

Asset protection is not exclusively within the domain of foreign trusts. One of the more common uses of trusts in the United States is for protection from creditors. Consider, for example, the spendthrift trust provision included in most trust agreements. Such provisions have been upheld in most jurisdictions except when the settlor retains control over, or benefits from, the trust. A sample spendthrift clause might be as follows: "No beneficiary of this trust shall have any right to sell, assign, pledge, mortgage or in any other manner encumber, alienate or dispose of either income or principal, nor shall such trust in any way become liable for

any indebtedness of the beneficiary or be subject to any legal process, bankruptcy proceeding, or the claims, interference or control of the creditors of such beneficiary.” In other words, if the settlor is not an intended trust beneficiary, a domestic trust will adequately protect the beneficiary’s interests from creditors in most jurisdictions.¹²

In one case, a New York court permitted a trustee to divide one testamentary trust containing real estate and marketable securities into two separate trusts to protect the marketable securities from possible future liabilities arising from ownership of the real estate.¹³

Generally, the settlor’s retention of the power to invade, control, or revoke the trust does not invalidate an inter vivos trust once it has properly been created.¹⁴ Nonetheless, most state laws provide that trust assets are available to satisfy the settlor’s debts by reason of the retained powers, whether the settlor is the sole beneficiary or not.¹⁵ This doctrine is referred to as the self-settled trust rule.¹⁶

Although the *Restatement of Trusts* provides that a creditor will be able to reach the maximum amount distributable to the settlor’s benefit, many planning possibilities exist for domestic trusts. For example, the settlor can create an irrevocable trust for the benefit of his spouse and children while retaining an income interest and a limited power of appointment, which makes the gift incomplete¹⁷ and allows the settlor to retain control over the final disposition. A creditor of the settlor would be able to reach only the income interest in such instance.¹⁸

Among the features of trust legislation of foreign jurisdictions are provisions that allow the settlor to (1) retain an interest as a beneficiary and (2) appoint himself as trust protector. Because many offshore jurisdictions still follow English common law (which applies the self-settled trust rule), great care must be taken in selecting a proper situs for the trust. The Isle of Man, Bermuda, the Cayman Islands, and Gibraltar have not enacted provisions overriding the self-settled trust rule. On the other hand, the law of the Cook Islands, for example, provides that a trust will not be declared void or be affected in any way by reason of the fact that the settlor either retains the right to revoke the trust or retains the power to dispose of trust property or remove or appoint a trustee or protector.¹⁹

Although the validity of the trust is not affected by the settlor’s right to revoke, it is generally recommended that the trust be irrevocable. If the trust is revocable, a creditor may be able to obtain an order compelling the settlor to revoke the trust. An anti-duress clause may protect against such revocation, but when the settlor wishes to establish the trust for a stated term, provision should be made to allow the trustee to extend the term of the trust indefinitely if creditor problems exist at the original termination date.

Sample Clauses

Flee Clause

There may come a time when a change of situs may be desired to protect assets from creditors, the threat of political instability, or a change in law. The trust agreement can include various provisions to permit a change of (1) trustees, (2) the situs of the trust, or (3) its assets. These provisions (often referred to as *flee clauses*) can give the trustee or a trust protector a discretionary power to change the situs by appointing new trustees, removing assets to another jurisdiction, or amending the trust to comply with the laws of a new jurisdiction.²⁰ A sample flee clause follows:

The Trustees may by a signed declaration in writing, at any time or times and from time to time, during the Trust Period, as they deem advisable in their discretion for the benefit or security of this Trust Fund or any portion hereof, remove (or decline to remove) all or part of the assets and/or the situs of administration thereof from one jurisdiction to another jurisdiction and/or declare that this Settlement shall from the date of such declaration take effect in accordance with the law of some other state or territory in any part of the World, and thereupon the courts of such other jurisdiction shall have the power to effectuate the purposes of this Settlement to such extent. In no event, however, shall the law of some other state or territory be any place under the law of which: (1) substantially all the powers and provisions herein declared and contained would not be enforceable or capable of being exercised and so taking effect; or (2) this Settlement would not be irrevocable. From the date of such declaration, the law of the state or territory named therein shall be the Applicable Law, but subject always to the power conferred by this paragraph and until any further declaration be made hereunder. So often as any such declaration as aforesaid shall be made, the Trustees shall be at liberty to make such consequential alterations or additions in or to the powers, discretions, and provisions of this Settlement as the Trustees may consider necessary or desirable to ensure that the provisions of this Settlement shall (*mutatis mutandis*) (with the necessary changes having been made) be so valid and effective as they are under the Applicable Law governing this Settlement at the time the power contained herein is exercised. The determination of the Trustees as to any such removal or change in Applicable Law shall be conclusive and binding on all persons interested or claiming to be interested in this Settlement.

It may be more desirable to make such transfer automatic upon the occurrence of certain enumerated events to avoid attempts to freeze assets in the trust's domicile. The trust agreement can authorize the

appointment of a custodian trustee as a standby trustee. If an action is commenced against the trust or the trustees in the original trust jurisdiction, the original trustee is automatically removed and the custodian trustee assumes sole responsibility. This would then force a creditor to commence an action anew in the custodian trustee's jurisdiction.

Anti-Duress Clause

If a trust permits the settlor to retain certain powers (e.g., to remove and replace trustees), a creditor may seek to compel the settlor to discharge the foreign trustee and arrange to repatriate the assets to the United States. Accordingly, an anti-duress clause should be included to direct the foreign trustee to ignore any order or instructions given under duress. The purpose of such a clause is to protect the settlor against acts of coercion by the U.S. court and possible exposure to contempt charges (impossibility of performance is a defense to contempt). The following is a sample anti-duress clause:

Settlor directs that this Settlement be administered consistent with its terms, free of judicial intervention and without order, approval, or other action of any court. To the extent any person is granted the power hereunder to compel any act on the part of one or more of the Trustees, or has the authority to render advice to one or more of the Trustees, or to otherwise approve or compel any action or exercise any power that affects or will affect this Settlement, each Trustee is directed, to the extent the respective Trustee then in office would not be subject to personal liability or personal exposure (for example, by being held in contempt of court or other such sanction by a court having jurisdiction over the respective Trustee): (i) to accept or recognize any instructions or advice, or the effects of any approval or compelled action or the exercise of any power, which are given by or are the result of persons acting of their own free will and not under compulsion of any legal process or like authority; and (ii) to ignore any advice or any directive, order, or like decree, or the results or effects thereof, of any court, administrative body or any tribunal whatsoever or of past or present Trustees, of any Protector hereunder, or of any other person, where (a) such has been instigated by directive, order, or like decree of any court, administrative body or other tribunal, or where (b) the person attempting to compel the act, or attempting to exercise the authority to render advice, or otherwise attempting to compel any action or exercise any power which affects or will affect this Settlement, is not a person either appointed or so authorized or the like pursuant to the terms and conditions of this Settlement.

Trustee Removal

Because domestic trustees can also be compelled by a United States court to take control over trust assets, the trust must permit the offshore trustee to remove any domestic trustee upon the occurrence of certain events. This would avoid the need to have the domestic trustee resign, which may subject the trustee to sanctions. An example of such provision follows:

Upon the happening of any of the events enumerated hereinbelow, the Trustees who reside in or are domiciled in a given country shall have the power and authority to remove from office one or more of the Trustees who reside in or are domiciled in another given country wherein the event has occurred, with no powers, authorities, benefits, or discretions of the Trustees so removed surviving such removal, and thereupon the Trustees so removed shall be divested of the title to any assets belonging to the Trust Fund. The enumerated events are as follows:

War, invasion, or revolution; confiscation or expropriation of assets, either with or without compensation; the termination of exchange control regulations favorable to the Trust Fund or the implementation of exchange control regulations unfavorable to the Trust Fund; the mandatory liquidation or dissolution of existing Trustees; the mandatory replacement of existing Trustees or the placing of limitations on the powers of Trustees other than in accordance with the terms or provisions hereof; devaluation or inconvertibility of the currency in which the Trust Fund assets are held; serious governmental threat to the ownership or free transfer of private property by citizens of the jurisdiction; the threat of or actual suspension or abrogation in whole or in part of this Settlement, or any contract with a party involved in the trust; the threat of or the actual compulsion of the Trustees to sell, transfer, or otherwise dispose of Trust Fund assets in a manner inconsistent with the terms and provisions of this Settlement. Removal pursuant to this power shall be effective immediately upon notice thereof to the Trustee so removed.

Trust Protector

The use of a trust protector or advisor is common among foreign trusts. This person (or a committee of trust protectors) has the power to replace trustees and veto certain actions by the trustees. The protector's powers should generally be drafted as negative powers and subject to the anti-duress provisions to protect against an order compelling the protector to exercise control over the trust. A sample trust protector clause might provide:

Notwithstanding anything to the contrary herein contained, and in particular anything conferring an absolute or uncontrolled discretion on the Trustees hereof, all and every power and discretion vested in the Trustees by this Settlement and incorporated herein by this reference shall only be exercisable by them subject always to the power of the Protector to veto any exercise by the Trustees of such power or discretion, and accordingly the Trustees shall be required to provide the Protector with reasonable prior notice before any such powers or discretions may be exercised so as to allow the Protector reasonable advance opportunity within which to veto or refrain from vetoing the exercise of the power or discretion. The Protector's exercise or nonexercise of this veto power shall be communicated in writing to the Trustees and failure to so communicate in a timely fashion, provided notice is actually received by the Protector, shall be treated by the Trustees as a veto by the Protector of the proposed exercise of the power or discretion; however, if one or more of the Trustees reasonably believe that failure by the Protector to so communicate is due to the Protector being restrained or enjoined from doing so, then such failure to communicate shall be treated by the Trustees and deemed for all purposes hereof as acquiescence by the Protector to the proposed exercise of the power or discretion. It is further provided that, notwithstanding anything to the contrary otherwise herein expressed or implied, no discretion or power conferred upon the Protector, or upon any other person by this Settlement or by any rule of law, or arising in consequence of the exercise of any power conferred upon the Protector, or any other person by this Settlement, shall be exercised, and nothing contained herein shall operate, so as to cause the Protector to be successful in ordering any action or causing any result that is not of the Protector's own free will, or that is otherwise the result of the Protector acting under duress or influence of an outside force.

Other Provisions

A major attraction of an APT is the ability of the settlor to retain a beneficial interest in the trust. The trustees may be given discretion to make distributions to the settlor (or any other family member), and if an attachment by creditors is likely, the trustees may be given discretion to make payments on the settlor's behalf for the settlor's support and comfort.

Because these trusts are generally structured as tax-neutral, they include grantor trust powers (for income tax neutrality) and the retention by the settlor of a limited power of appointment and a veto power over distributions to render the gift incomplete.²¹ It is also possible to

structure these trusts to qualify as U.S. trusts for tax reporting purposes²² and thereby avoid certain U.S. reporting requirements.²³ Finally, because these trusts can be used as will substitutes, most estate planning provisions found in typical revocable trusts or wills can be incorporated.

Conclusion

Although the effectiveness of an APT depends on many factors, including the manner in which the trust is drafted, the trustees selected, the expertise and skill applied in attacking the trust, and the expertise and skill used in defending it, the ultimate outcome may turn on the jurisdiction selected. In this author's experience, the existence of a properly structured foreign situs trust has enabled clients to avoid protracted litigation and settle claims for amounts substantially less than would have otherwise been possible.

Notes

1. Anguilla, Antigua, Bahamas, Barbados, Belize, Bermuda, Cayman Islands, Cook Islands, Cyprus, Gibraltar, Hungary Labuan, Liechtenstein, Marshall Islands, Mauritius, Nevis, Niue, Panama, St. Vincent, Seychelles, Turks and Caicos.
2. S.C. Bar Adv. Opinion 84-02 (May 25, 1984).
3. *See also In re Renard*, 437 N.Y.S.2d 860 (NY. Sup. Ct. 1981), involving choice of law for a French domiciliary.
4. I.R.C. § 679.
5. §§ 673-677.
6. §§ 6048(c) and 6677(a).
7. *See, e.g., United States v. Popkin*, 943 F.2d 1535, 68 A.F.T.R.2d 91-5823, 91-2 U.S.T.C. ¶ 50,496 (11th Cir. 1991).
8. Bahamas, Bermuda, Cayman, Cook Islands, Gibraltar, Mauritius, Nevis, St. Vincent.
9. Cook Islands, Labuan, Nevis, Belize, and St. Vincent adopted such a provision.
 10. Nevis International Exempt Trust Ordinance § 55.
 11. Bahamas Fraudulent Disposition Act 1991.
 12. *See generally* Bogert, TRUSTS AND TRUSTEES § 2 (2d rev. ed. 1984); N.Y. EST. POWERS & TRUSTS LAW § 7-1.5(a)(1), N.Y. C.P.L.R. § 5205(c); *In re Vought*, 303 N.Y.S.2d 61 (N.Y. CT. App. 1969).
 13. *In re Goldberg Irrevocable Trust*, 159 Misc. 2d 1107, 608 N.Y.S.2d 382 (Surr. Ct. N.Y. County 1994).
 14. *In re Estate of Kovaiyshyn*, 343 A.2d 852 (N.J. 1975).
 15. *Vanderbilt Credit Corp. v. Manhattan Bank*, 473 N.Y.S.2d 242 (1984); N.Y. EST. POWERS & TRUSTS LAW § 10-10.6; Cal. Prob. Code § 18200.
 16. RESTATEMENT (SECOND) OF TRUSTS § 156 (1957).
 17. Treas. Reg. § 25.2511-2(b). *But see* CCA 201208026.

12 Establishing and Drafting Offshore Asset Protection Trusts

18. *Avera v. Avera*, 315 S.E.2d 883 (Ga. 1984).

19. Cook Islands International Trusts Act (1984, as amended 1989 and 1991), § 13C.

20. *See, e.g.*, § 13K(5) of the Cook Islands International Trusts Act, 1984 as amended, which provides that the original trust settlement date governs such redomiciled trusts for purposes of the statute of limitations.

21. *See* Ltr. Rul. 9536002 for an analysis of the gift tax and grantor trust issues of a foreign situs trust (1995).

22. I.R.C. § 7701(a)(31).

23. *See supra* note 6.