ASSET PROTECTION TRUSTS

-What They Are-

-How They Work-

-Tax Aspects-

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INTRODUCTION:

This article is driven by the rapidly developing and largely unevaluated emergence in the United States of the offshore asset protection trust. Section I of this article explains what an asset protection trust is, section II deals with jurisdiction selection and particularly analyzes the laws of the Cook Islands, section III evaluates the effectiveness of an asset protection trust assumed to be settled on the Cook Islands and; finally, section IV discusses the tax aspects of a typical asset protection trust. Just as important as what this article will discuss is what it will not. It will not discuss, except in passing, (1) the state and federal fraudulent conveyancing laws, (2) other asset protection techniques or (3) the laws of any jurisdiction,[1] other than the Cook Islands, which

[1] For a listing of the jurisdictions known to this author which have enacted or announced an intention to consider legislation relating to offshore asset protection oriented trusts *see*,

fosters asset protection trusts. Appendix A is a consolidation of the Cook Islands International Trusts Act, 1984, as amended.[2]

I. WHAT IS AN ASSET PROTECTION TRUST?

A. Definition[3]

An asset protection trust is any trust formed for a term of years in a foreign jurisdiction which:

1. either does not recognize or imposes significant barriers to the recognition of United States judgments,[4]

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section II.B. *infra*.

[2] At the present time there is little published material on asset protection trusts. The domestic sources which have been the most helpful to the author are: Grey and Luria, *Protection of Asset Trusts*, 130 Trusts and Estates 32 (1991); speaker's notes entitled *Asset Protection Planning - The Concept, the Trends & the Tools* by Engel at the May 1993 New York University School of Law Tax Institute; speakers' notes entitled *Use and Abuses of Foreign Asset Protection Trusts* by Leinwand, Norman and Warner at the February 1993 University of Southern California School of Law Annual Tax Institute and speaker's notes entitled *Asset Protection Techniques* by Henkel at the February 5, 1993 meeting of the American Bar Association Section of Taxation, Small Business Committee (all available at the New York University School of Law Library).

[3] An asset protection trust could be defined as any trust settled in a jurisdiction which offers enhanced protection from creditor attacks. The definition utilized in this article is somewhat artificial but is reflective of how most trusts formed for asset protection purposes are structured.

[4] Some jurisdictions simply do not recognize United States judgements and require a trial *de novo*. Other jurisdictions have a procedure whereby certain United States judgements can be recognized (usually not penal or fiscal in nature) provided certain procedural hurdles (which may amount to a mini-trial) are met. No country in the world automatically enforces judgements from any United States court. This is probably because all other nations are worried about one aspect or another of our anti-trust, environmental, securities and tort laws.

2. has enacted a Statute of Elizabeth override provision,[5] and

3. imposes strict procedural barriers to actions brought in that jurisdiction attacking trusts settled in that jurisdiction.

Normally, at least if the settlor of this trust is a United States resident, the trust will also:

4. be irrevocable for a period of years,[6]

5. have beneficiaries other than the settlor,[7] and

6. position the settlor as a contingent remainderman.[8]

For an excellent overview of the law in this area *see*, Lowenfeld, International Litigation and Arbitration (West 1993) particularly chapter 5 entitled *Enforcement of Foreign Judgements.*

[5] The terms "Statute of Elizabeth override provision" or "anti-Statute of Elizabeth provision" refers to a modification to traditional U.K. fraudulent conveyance laws eliminating or reducing the protection afforded future unanticipated creditors. These terms are often loosely and somewhat imprecisely applied to refer to laws enacted in foreign jurisdictions which make it very difficult or impossible to have the courts of that jurisdiction recognize and enforce a judgement from a different jurisdiction. The laws in these jurisdictions usually require a trial *de novo*, applying their own fraudulent conveyancing laws. Usually the burden of proof for the aggrieved creditor will be higher (*e.g.*, "beyond a reasonable doubt"), the statute of limitations will be very short and, sometimes, the new jurisdiction will only allow creditors existing at the time of the transfer (and not creditors coming into existence after the transfer) to bring claims. For a detailed discussion of fraudulent conveyances and the Statute of Elizabeth *see* Debtor Creditor Law chapter 22. For a detailed discussion of the procedural barriers which creditors must overcome to reach the assets of a trust settled on the Cook Islands *see* Section II.C. *infra*.

[6] The term of the trust is extended if the assets are in jeopardy. *See* section I.D.8. *infra*.

[7] The beneficiaries will be designated by the settlor and can normally be changed at any time by the settlor to anybody other than the settlor. Sometimes when domestic creditor protection is not required for the entire life of the trust (*e.g.*, when the settlor is expatriating and has no other assets subject to the jurisdiction of any United States court) this prohibition on the settlor naming himself as a beneficiary is structured to be temporary or to terminate upon the occurrence of certain specified events. *See* section I.D.7. *infra*.

[8] These last three trust characteristics are generic to most asset protection trusts but are not technically "requirements." These factors are important from a domestic asset protection

At the termination of the trust all undistributed trust assets, including the original *res* and all income earned thereon, is returned to the settlor. Distributions are normally discretionary with the trustee whose actions will be guided by a Committee of Trust Advisors (often chaired by the settlor).[9] In the event of a creditor attack threatening the assets in any way, the termination of the trust will be delayed until the assets can be safely distributed to the settlor or the beneficiaries of his choice. In the event that the trust or its assets are subject to aggressive attack in the foreign jurisdiction, the situs of the trust will be changed (perhaps automatically) to a new and undisclosed jurisdiction. A properly settled asset protection trust is very difficult to penetrate.

B. Settlement of the trust.

An asset protection trust is best thought of as a legitimate and internationally recognized vehicle for a solvent and substantial person to place a portion of his wealth into a secure entity which allows that person substantial control over the assets yet protects these assets from future unanticipated creditors.[10] Where the settlement of the trust occurs long before any significant

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point of view only because they are typical steps taken to prevent the settlor's interest in the trust from being available to creditors of the settlor under United States law simply because of the trust structure itself. It is widely accepted under domestic law that the settlor's interest in a trust structured with these three characteristics is so contingent and undefinable that it is unreachable by the settlor's creditors. *See,* section III.A.1(d) *infra* and Debtor Creditor Law Section 37.03.

[9] Sometimes the trustee will be a corporation controlled directly or indirectly by the settlor. *See,* sections I.D.7., II.B.2. and II.C.8. *infra*.

[10] The Ethics Advisory Committee of the South Carolina Bar has ruled that an attorney can participate in a transfer of a clients property where the sole purpose of the transfer is to avoid the possibility of a deficiency judgement from an identified creditor provided that there is no "immediate reasonable prospect" of a judgement being entered. Opinion 84-02 (May 25, 1984) The Committee on Professional Responsibility and Conduct of the State Bar of California has refused on two occasions to take a stand on this matter deciding that the

creditors or liabilities materialize and where the transfer involves only a portion of the settlor's assets, leaving him patently solvent after the transfer, the asset protection trust is a very effective tool. It is rarely this simple in practice.

One overriding concern for the settlor and his advisors is that no transfers to the trust be violative or any state or Federal fraudulent conveyancing laws.[11] Often a prospective settlor will defer asset protection planning, including the settlement of an asset protection trust, until he is beset with liabilities, lawsuits and sometimes judgment creditors. Advisors must be very careful in these circumstances because, even though the planning might be effective to protect the asset from creditors,[12] all participants in the transaction, including the advisors to the debtor, may be subjected to civil and criminal liability.[13]

A through discussion of the fraudulent conveyancing provisions of the various jurisdictions is beyond the scope of this article and covered well in other sources.[14] However, it

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question was a "legal" and not an "ethics" issue. *See,* Ethics Opinion 92-0005. *See also* California Ethics Opinion 91-0004.

[11] *See*, Debtor Creditor Law chapter 22.

[12] *See*, section II.A.3. *infra*.

[13] *See*, sections III.A.3.(c)-(g) *infra*.

[14] For a good comparison of the fraudulent transfer provisions of The Bankruptcy Code of 1978, as amended (11 U.S.C. sections 101 to 1330) [hereinafter Bankruptcy Code] with the Uniform Fraudulent Conveyance Act (the basis of law in New York) and the Uniform Fraudulent Transfer Act (the basis of law in California) *see* Debtor Creditor Law chapter 22 and Collier on Bankruptcy, section 548 (Lawrence P. King, Editor-in-Chief, Matthew Bender) [hereinafter Colliers]. *See also*, Cook & Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 Am. Bankr. L.J. 87 (1988); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829 (1985) and Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 Bankr. Dev. J. 55 (1991).

is worth analyzing whether or not the simple act of settling an asset protection trust, the sole admitted purpose of which is to insulate the transferred assets from creditor attack, is, in and of itself, sufficient to cause the transfer to the trust to be vulnerable in domestic courts as a *per se* fraudulent transfer.

The problem arises because all of the sets of domestic fraudulent conveyancing laws[15] under which a transfer to an asset protection trust might be analyzed have one thing in common. Every transfer with the "actual intent" to delay, hinder or defraud creditors is subject to attack, even if the creditor is a future unanticipated creditor at the time of the transfer. There are no cases directly on point although some authority exists for the proposition that a transfer to a single purpose trust designed to protect assets from future unanticipated creditors is permissible.[16]

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[15] A transfer may be analyzed under the section 544 of the Bankruptcy Code or state law. All states have either a version of the Uniform Fraudulent Transfer Act, The Uniform Fraudulent Conveyance Act or a modernized Statute of Elizabeth. *See*, Debtor Creditor Law section 22.01.

[16] *See*, *re Oberst* 91 B.R. 97, 101, B. L. R. (CCH) Paragraph 72,462 (Bankr. C.D. Cal 1988) in which the court, holding against the debtor, stated in *dicta* that "If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, [the conveyance would not be fraudulent and] the discharge will be granted." *See also, Klein v. Klein et al.* 122 N.Y.S.2d 546 (1952), *Wantulok et al. v. Wantulok* 214 P.2d 477 (1950). In *Hurlbert v. Shackleton* 560 So. 2d 1276 (1990) Dr. Shackelton, an obstetrician, transferred assets "[b]ecause I wasn't able to get malpractice insurance, and I wanted to cover all the bases" (at 1278). Dr. Shackelton committed an act of alleged malpractice and suite was brought. Dr. Shackelton made transfers both before and after the suit was filed. The transfers were complete before the judgement was entered. The judgement creditor was found on appeal to not be subject to protection unless Dr. Shackleton was found to have harbored actual fraudulent intent. The court cited the trial court with approval noting "[t]the trial court drew a distinction between "probable" and possible" future creditors. Classifying appellant as a "possible" future creditor, the court said that it found no

Historically, because of the difficulty in proving actual subjective intent to defraud a creditor, common law courts have pointed to "badges" of fraud as evidence of the settlor's subjective intent.[17] Any asset protection planner should be familiar with these "badges" and should document any transfer to minimize these factors. The badges identified by the Uniform Fraudulent Transfer Act which may be utilized to infer actual subjective intent are whether or not:

> "1. the transfer or obligation was to an insider;
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> 2. the debtor retained possession or control of the property transferred after the transfer;
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> 3. the transfer or obligation was disclosed or concealed;
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> 4. before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
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> 5. the transfer was of substantially all of the debtor's assets;
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> 6. the debtor absconded;
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> 7. the debtor removed or concealed assets;
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> 8. the value or the consideration received by the debtor was reasonable equivalent to the value of the asset transferred or the amount of the obligation incurred;
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> 9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
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> 10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and

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cases holding a transfer of assets to be fraudulent as to "possible" future creditors" (at 1279). The appellate court remanded for a finding of fact on Dr. Shackelton's actual intent.

[17] *See*, Debtor Creditor Law sections 22.02 and 22.04[A].

11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor."[18]

In addition to minimizing these "badges", a careful planner should emphasize the other business justifications for the settlement of a foreign trust. Provided a trust is properly crafted and careful settlement procedures are followed, the issue of whether or not a trust formed with the sole purpose of protecting assets from creditors is *per se* fraudulent should never come up because any carefully conceived plan will document substantial and independent business justifications for the trust. Careful justification of the independent business reasons for the foreign trust should make it difficult for an aggrieved creditor to effectively argue that a transfer which was not fraudulent under any objective criteria was nevertheless fraudulent because the transferor harbored some internal subjective actual fraudulent intent.[19]

C. Practical uses of asset protection trusts

The following is a partial list of some of the uses of foreign trusts with asset protection characteristics. Some relate to asset protection and some relate to general business

[18] *See,* Debtor Creditor Law chapter 22.

[19] A highly analogous area is taxation (particularly corporate reorganizations and international) where a taxpayer may structure a complex transaction which, because of its form, saves taxes. The Internal Revenue Service attacks these transactions on a "substance over form" basis. The best defense to a substance over form attack is to carefully document the business purpose for the seemingly awkward form. On the occasions where a valid business purpose is documented, the Internal Revenue Service has met with only limited success in unwinding transactions. *See,* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders (WGL 1993). Although no cases are on point in the asset protection area, the same reasoning applies.

considerations. When documenting the trust the business oriented justifications for settlement of the trust should be emphasized.

1. Supplement or replacement to insurance

An important motivating factor for the settlement of an asset protection trust is the dramatic rise in the United States of both the number of lawsuits and the magnitude of verdicts.[20] New theories of liability are being created everyday[21] and suits are being brought more often.

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[20] There are literally countless examples, a few of which follow:

Annually, there are 13.9 malpractice claims for each 100 doctors. Four out of ten medical doctors have been sued. The average Obstetrician in New York has been sued eight times and many are leaving the field. Nationwide the average verdict against doctors is $1.33 million and in New York it is three times larger. *See,* Gastel, *Medical Malpractice*, Insurance Information Institute Reports (June, 1993).

The same is true in many other professions. Currently there are over 3000 suits against accountants in the United States seeking more than $13 billion in damages. Huge judgements, like the recent $338 million judgement against Price Waterhouse are being obtained. Several large regional firms have gone bankrupt. *See,* Lee, *Ex-Firm Returns to Haunt Partners*, Los Angeles Times, February 16, 1993, (Business), at 3.

Investors are also beset by uninsured risk. A group of the now senior partners in an international consulting firm bought a large parcel of raw land in the 1970's which they held for development. These people, all in their 60's, recently received a notification under CERCLA than their anticipated joint and several liability for toxic clean-up costs is estimated to be $72 Million. CERCLA did not even exist at the time these people acquired the land. These partners had errors and omissions insurance for their practice and liability insurance on their real estate and vehicles. They were very passive investors and assumed they were completely safe and protected. None had implemented an effective asset protection program.

[21] For example, new legal theories are developing which hold lawyers, accountants and other similar professionals liable for their client's malfeasance in circumstances where the professional has the depth and length of relationship with that client so that any reasonable person should suspect that something was amiss. In actual practice, these precedents are being utilized with substantial success to frame complaints where the advisor has little or no relationship with the client. When faced with a jury trial, settlement is often the result, even with baseless claims. *See, International Mortgage Company v. Butler Accountancy*

"More than 18 million civil suits were filed in this country in 1989 - one for every 10 American adults...."[22]

Some professionals utilize asset protection trusts as an adjunct[23] or replacement to insurance.[24] As malpractice rates rise, many professionals are reducing their coverage but still preserving their right to a defense under their policy, and implementing asset protection trusts. On occasion, these professionals go completely bare, particularly once all of the relevant statute of limitation periods have expired. Many individuals believe that heavy insurance in the current judicial climate serves to draw litigation and that by reducing or eliminating the size of the potential recovery the incentive of any claimant to institute and pursue litigation is likewise reduced.

2. A tool to settle or discourage litigation

Few lawsuits are brought on principle, particularly if the lawyer for the plaintiff is being compensated on a contingent fee basis. Once the plaintiff and his attorney discover that a properly settled[25] and implemented asset protection plan[26] is in place and that any judgment will

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Corporation, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986). *See also, Attorney's Liability to One Other than his Immediate Client, for Consequences of Negligence in Carrying out his Legal Duties*, 45 ALR 3d 1181 (1991) and *Liability of Public Accountant to Third Parties*, 46 ALR 3d 979 (1972).

[22] Vice President Dan Quayle, Prepared Remarks at the Annual Meeting of the American Bar Association (August 13, 1991).

[23] Most policies are found to be quite porus when they are actually reviewed.

[24] The insurance may be any type, including professional malpractice (errors and omissions), tail or director's and officer's liability.

[25] This is normally an "old and cold" trust. Note, however, it is possible in many situations to still implement asset protection plans involving foreign trusts even after a claim

be difficult or impossible to collect, their motivation to proceed with litigation fades. One principal effect of a carefully crafted plan is the destruction of the plaintiff's economic incentive to litigate.

3. To keep the ownership of assets confidential[27]

The confidentiality and secrecy laws of many offshore jurisdictions are taken very seriously and in fact impose criminal penalties for their violation. Notwithstanding the near absolute secrecy permitted by some jurisdiction the settlor should be aware that the settlement of an offshore trust normally does not result in any tax savings[28] or mean that the United States government utilizing the resources of FinCEN[29] cannot discover the trust pursuant to a governmental investigation.

4. An alternative to traditional pre-nuptial agreements.

An unmarried person may normally settle an offshore trust without the consent of his prospective spouse. The offshore trust will normally protect the transferred assets in the event of

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has been made or a lawsuit has been filed provided the fraudulent conveyancing laws and related statutes are not violated. *See,* section III.A.3. *infra*.

[26] This plan will normally involve entities other than an asset protection trust (*e.g.,* the family limited partnerships discussed in section III.A.1.(b)(ii) *infra*, the emerging limited liability company and perhaps foreign corporate or *quasi* corporate entities) and often more than one foreign jurisdiction.

[27] Secrecy laws and traditions developed during the days of the Third Reich, beginning before World War II, to counteract the Nazi's near omniscient presence in Germany. *See,* Crawford, *Who Needs Offshore Centers?*, International Herald Tribune, April 24, 1993, (Money Report) [herein Crawford].

[28] *See,* section IV. *infra*.

[29] *See,* section III.A.3(f) *infra*.

a divorce. The primary difference is that the prospective spouse does not need to consent to the transfer (in fact, the spouse need not even know of the transfer).[30] Offshore trusts are also sometimes useful in pre-divorce planning (e.g. to keep an expected inheritance segregated as separate property). In all cases, an asset protection trust is an estate planning instrument with the same dispository effect of a traditional domestic trust.

5. A hedge against potential exchange controls

One managing director of a substantial bank in the Cayman Islands recently remarked, "Exchange controls were firmly in place in the United Kingdom before [former Prime Minister] Margaret Thatcher, and one can't be certain that they will never be reintroduced. In the U.S., with the shape of its national debt, I would not be surprised at all if limits on foreign investment were adopted. The U.S. has had such limits before, in certain forms."[31]

6. Miscellaneous uses of asset protection trusts

Asset protection trusts can in certain circumstances be utilized:

(a) To protect pension assets: Certain assets in certain types of pension plans are not accorded protection under state or Federal law.[32] An asset protection trust can be utilized to protect assets otherwise exposed.

(b) To give an insolvent debtor a fresh start: On occasion, particularly when bankruptcy is not a currently valid option, an insolvent debtor who is entrepreneurially minded

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[30] *See,* section III.A.2. *infra*.

[31] *See,* Crawford, *supra*.

[32] *See,* Debtor Creditor Law section 37.03[B].

may separate and insulate future start-up business ventures which are unrelated to his current activities from past creditors by the use of offshore trusts. Extreme care must be taken to analyze the fraudulent conveyancing issues.

(c) To avoid forced heirship laws: Certain jurisdictions, particularly in Europe, have forced heirship laws. Offshore trusts have traditionally been utilized to avoid the impact of these laws.

(d) A hedge against governmental instability.

D. What are the legal characteristics of a typical Asset Protection Trust?

A carefully designed asset protection trust should achieve the following legal results:

1. Creditor protection - derived from situs: This is achieved by subjecting the trust to the laws of an offshore jurisdiction with specifically enacted asset protection legislation.[33]

2. Creditor protection - derived from structure of trust: Asset protection trusts, even though they are foreign trusts, are often structured to divorce the settlor from all indicia of ownership. The settlor will not be the trustee, he will often be prohibited from ever becoming a beneficiary and the trust will be irrevocable for a substantial number of years. Normally, applying domestic law, as long as the trust is irrevocable for a period of years and the settlor is not a beneficiary but merely retains a contingent reversionary interest, the trust assets should be unassailable during the period of irrevocability provided that the trust is not formed in violation

[33] *See,* section II.B. *infra*.

of any fraudulent conveyancing laws.[34] Judgment creditors stand in the same relationship to the trust assets as does the settlor/debtor.

This structure is traditionally adopted for evidentiary reasons to minimize one of the traditional "badges" of fraud which is the debtor's "continuance in possession and ability to represent the goods as his own."[35] By structuring the trust so that the debtor is nothing but a "mere contingent remainderman" under domestic trust law it is thought that the transfer is less likely to be characterized as fraudulent. This form of structure is usually not required for a trust to provide effective asset protection.[36] It is also not normally required by the jurisdiction in which the trust is settled. For example, the settlor can usually be the beneficiary underthe law of the jurisdiction of settlement

3. Tax neutral: An asset protection trust with a United States citizen or resident as the settlor should normally be structured to be tax neutral.[37] The principal additional burden, which is triggered in the cases where the trust is classified as "foreign" (for tax purposes), is that the trust should not be the shareholder of a Subchapter S corporation and it must comply with specified reporting requirements.[38] Utilization of an asset protection trust does not increase nor decrease the tax burden on the settlor of the trust who is treated, for tax purposes alone, as the

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[34] *See,* Debtor Creditor Law chapters 22 and 22A as well as section 37.03; *See also,* Note, *Creditors' Rights Against Trust Assets*, 22 Real Prop. Prob. & Tr. J. 735 (1987).

[35] *See,* Debtor Creditor Law section 22.02.

[36] *See,* section III.A.3 *infra* which illustrates that an asset protection trust can provide effective protection even if settled in violation of a domestic fraudulent conveyancing statute.

[37] *See,* section IV. *infra*.

[38] *See,* section IV.F. *infra*.

owner of the assets and grantor of the trust.[39] The United States tax treatment of an offshore asset protection trust, where the "mere remainderman" is treated as the owner of the trust assets and is taxed on all of the income therefrom, is completely opposite from his treatment under domestic debtor creditor law, where the "mere remainderman" is technically divorced from ownership with the result that the assets placed in trust are not subject to attachment by his creditors.

4. No criminal or civil violations: The provisions of the trust and the circumstances surrounding its formation must not violate any criminal provisions or create civil liability.[40] There are criminal penalties applied against the settlor, and his attorney, for certain types of fraudulent transfers to a trust[41] and for failing to meet certain Federal filing requirements.[42]

5. Withdrawal of funds: In certain circumstances, particularly where the settlor is rendering substantial services to the Committee of Trust Advisors or working for a corporation or partnership owned by the trust, the settlor may, in his or her capacity as consultant or employee, be able to extract funds from the trust as compensation. Of course, the compensation

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[39] *See,* B. Bittker and L. Lokken, Federal Taxation of Income, Estates and Gifts (WGL) particularly chapters 65-79 [hereinafter Bittker & Lokken]; Zaritsky, *Foreign Trusts, Estates and Beneficiaries*, T.M. (BNA 1993) [hereinafter Zaritsky].

[40] There are at least two jurisdictions involved, the jurisdiction of the settlor and the jurisdiction in which the trust is established. Ideally neither criminal nor civil liability are created in either. Nevertheless the trust may survive and the assets may be protected even if criminal or civil liability is created in the jurisdiction of the settlor, as long as the laws of the jurisdiction in which the trust is established are scrupulously observed. *See,* section III.A.3. *infra*.

[41] *See,* section III.A.3(f) *infra*.

[42] *See,* section IV.F. *infra*.

must be reasonable in light of the particular services provided.[43] The extraction of funds from the trust by the settlor is evidence of "continuance in possession and ability to represent the goods as his own," one of the traditional "badges of fraud."[44]

6. Will substitute: The asset protection trust is a will substitute. It should contain all of the appropriate estate planning devices which would be contained in a domestic trust and be coordinated with a comprehensive estate plan. The trust often will, and indeed should for important gift tax considerations,[45] provide that the Settlor has the power to change the beneficiaries of the trust; usually also providing that he does not have the power to designate himself as a beneficiary. In addition, the trust will usually provide that the trustee may make distributions of income or principle to the designated beneficiaries, subject perhaps to a veto by the Committee of Trust Advisors. The trust may also provide for distributions for charitable purposes or for certain non-charitable purposes.[46]

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[43] This problem concerning unreasonable compensation usually arose in old tax cases where taxpayers tried to avoid the double tax on dividends by taking the money out as deductible salary. *See, Compensation of Corporate Officers who as Directors Determine Own Compensation*, 53 A.L.R. 3d 358. Any salary, particularly if it is large in light of the services rendered, is strong evidence that the settlor/remainderman may have undisclosed powers over assets which may make assets reachable by creditors. In such case the settlor's assets in a domestic trust may be reachable by a judgement creditor. *See,* section III.A.1(d) *infra*. If the same debtor had a properly crafted foreign asset protection trust the assets in the trust would be difficult or impossible to reach. *See,* section III.A.3. *infra*.

[44] *See,* Debtor Creditor Law section 22.02.

[45] *See,* section IV.C.1. *infra*.

[46] It is a general principal of common law that every trust must have a human beneficiary to enforce it and it must be for a proper purpose. Most jurisdictions with asset protection legislation specifically authorize both charitable trusts (often applying a much looser definition than that traditionally provided by I.R.C. Section 501(C)(3)) and purpose trusts

7. Assets safe and either managed by settlor or professional management approved by the settlor: There are many techniques to achieve this result without subjecting the settlor or assets to collateral attack. In the case of a trust holding liquid assets it can, in many circumstances, be as simple a matter as holding the assets in a limited partnership in which the trust is the limited partner and the general partner is a corporation controlled[47] indirectly or perhaps even directly by the settlor. Alternatively, the trust might keep its liquid assets with a bank or brokerage firm. For example, dollar denominated investments, such as U.S. stocks and bonds, could be held in non-certificated form usually by an institutional custodian and be accounted for in the books of the custodian. In many cases, particularly where the settlor is satisfied with specifying both the type of investment (*e.g.,* a category of municipal bonds) and the classification of the custodian (*i.e.,* banks meeting certain criteria),[48] the settlor may be satisfied with only a "blind trust" type of report in which only the performance of the portfolio and not the location of assets or the identity of the manager or assets, is actually reported. This

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set-up for non-charitable purposes such as to benefit an animal or class of animals, a building or a tomb. *See,* section 12 of the Cook Islands International Trust Act 1984, as amended [hereinafter Cook Act] which specifically authorizes charitable trusts and purpose trusts which "may benefit privately one or more persons or objects or persons within a class of persons." *See,* section II.C. *infra* and Appendix A.

[47] *See,* section III.A.b. *infra*.

[48] Great care must be taken in selecting this pre-approved list. The pre-approved institutions should be substantial but, ideally (at least once an event of duress occurs), should not have a presence in the United States. *See,* sections I.D.8. and III.A.3(h)(iii) *infra*.

type of custodial service is offered by substantial institutional custodians in most offshore centers.[49]

In addition, it has become traditional for asset protection trusts to provide for "Protectors" or a "Committee of Trust Advisors." These committees are normally composed of the settlor, his or her attorney or trusted advisor, such as an accountant, as well as an attorney in the jurisdiction where the trust is established.[50] This committee will have veto power over all investment and distribution decisions of the trustee and will have power to replace the trustee. Often the trustee is guided by a non-binding "letter of wishes" delivered to the trustee by the settlor upon the settlement of the trust. Trustees will traditionally not depart from the non-binding instructions contained in the letter of wishes. In addition, in certain jurisdictions there are companies which are full time professional "protectors."

Some jurisdictions (*e.g.,* the Cook Islands and Bermuda[51]) permit the settlor to establish a privately owned trustee company to serve as trustee of the trust. Normally, such a company will have provisions in its Articles of Association similar to duress provisions so that on the occurrence of specified events the ownership of the company is specifically transferred away

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[49] For example, Stephen B. Breed, Chief Executive, International Trust Corporation Limited, Rarotonga, Cook Islands points out that "Often the signatory provisions on the fund management accounts require the joint signatures of the trustee and the ...protector. Thus, the settlor has the comfort ...[that the trustee] cannot do anything without his approval. Equally, it is not possible, if an event of duress has occurred, for the settlor to require the trustee to do anything." Personal communication (June 22, 1993).

[50] *See,* section 13D(i) of the Cook Act which specifically contemplates the involvement of such persons and specifically makes any foreign judgement against such person unenforceable in the Cook Islands.

[51] *See,* section II.B.4 *infra*.

from the settlor or anybody associated with the settlor. In some jurisdictions it may be possible to structure the ownership of the trustee company so that the settlor retains basic control of the trustee company (perhaps by the use of bearer warrants) but does not retain legal ownership as a shareholder.[52]

8. Duress provisions: The trust will contain "duress" provisions. If the trustee or the trust assets are threatened in any way whatsoever, the duress provisions will be triggered. The key duress provisions are as follows:

a. Automatic extension. In duress, the term of the trust is extended, automatically or at the discretion of the trustee, if creditors appear near the end of the term of the trust or an event constituting "duress" occurs.

b. Removal of assets. In duress, the trustee is directed to remove the assets from any jurisdiction in which the trustee believes that they may be subject to seizure.

c. Selection of alternate trustee and jurisdiction. In duress, the trustee may be instructed to appoint a different trustee in another, or any one of several, enumerated asset protection oriented jurisdictions and arrange to have the trust become subject to the laws of that jurisdiction. Under some types of provision this can happen automatically. For example, if a court in the offshore situs of the trust was petitioned to order a trustee subject to the jurisdiction

[52] Section 228B of the Cook Islands International Companies Act specifically contemplates duress provisions in Articles of Association which automatically transfer ownership. Stephen B. Breed, Chief Executive, International Trust Corporation Limited, Rarotonga, Cook Islands, notes "[T]he holder of...[a bearer] warrant is deemed [under Cook Islands law] not to have any shareholding interest but has an entitlement to convert to a shareholding interest if he so wishes. This sort of facility maybe useful when used in conjunction with Section 228B [of the International Companies Act.]" Personal communication (June 22, 1993).

of that court to surrender assets, the trustee could be automatically removed as trustee and the jurisdiction of the trust switched to a different jurisdiction. Each of these duress provisions is specifically designed to frustrate collection efforts. A United States court would most probably find these provisions to be evidence ("badges") of an intent to defraud creditors under the various fraudulent transfer acts.[53] These types of clauses are known as "Cuba clauses" and are authorized by statute in many jurisdictions.

9. Settlor protected from contempt. The trust is structured so that any instructions received by the trustee from the settlor or any beneficiaries which are delivered pursuantto court order are deemed given under duress and are to be disregarded. Any act taken by the settlor under duress will be ineffective to bring the assets within the ordering court's jurisdiction. As a result, the settlor can fully comply with any court orders to instruct the trustee to deliver assets.[54]

10. Trust treated as valid legal entity. The trust and the transfer of assets to the trust should be regarded as a transaction worthy of judicial respect, having legal substance, and not a mere sham. All formalities required by the United States and the foreign jurisdiction, including registration, are observed, with the expectation that this will start the running of any statute of limitations, at least in the foreign jurisdiction.[55]

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[53] *See,* section I.B. *supra*.

[54] *See,* section III.A.3(c) *infra*.

[55] *See,* section II.A.1(d) *infra*.

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SECTION II

II. SELECTION OF JURISDICTION IN WHICH TO FORM TRUST

A. General Considerations:

Many factors must be considered before selecting a jurisdiction in which to establish an asset protection trust. The decision must be based upon a review of the relevant statutory law, the case law if any, the availability of trustworthy co-counsel and the existence of an acceptable trust company. Great care should be taken to choose a jurisdiction which allows the settlor to best achieve his or her goals. The specific laws of the jurisdiction should be checked with respect to the following factors:

1. Common Law heritage: Does the jurisdiction have a common law heritage with a specific history of recognizing trusts? Civil law jurisdictions which recognize trusts (i.e. Liechtenstein) create their trust law by statute and do not deal with them in the manner in which we are accustomed in the United States. In addition, certain United States tax provisions regarding the classification of trusts[56] may require that the jurisdiction apply the principles of chancery courts.

[56] *See,* section IV.B. *infra*.

2. Creditor protection: Does the statute provide adequate insulation against creditors? Each jurisdiction has different Statute of Elizabeth override provisions and has different procedures and standards of proof to enforce judgments within its jurisdiction.

3. Tax consequences: The tax consequences of settlement in a specific jurisdiction should be verified. Normally there is not a tax treaty. Most jurisdictions have little or no tax initially but some jurisdictions impose higher taxes once a tax holiday is over.

4. Transfer Statute: The transfer statute of the host jurisdiction must be checked to verify that the domicile can be quickly and automatically transferred in the event of an event of Duress.[57]

In addition, other factors such as cost and availability of international communication links and the jurisdiction's history of political stability should be considered.

B. Jurisdictional overview The following is a list of the majority of jurisdictions[58] which have enacted or are evaluating enacting Statute of Elizabeth override provisions or other

[57] In many jurisdictions (*e.g.,* Switzerland or the Netherlands), an attempted transfer of jurisdiction will not be given legal effect in the absence of a transfer statute.

[58] This list is incomplete and changing on an almost monthly basis. Many island protectorates are going to have the option of independence in the next decade. When they look at the positive fiscal impact of legislation encouraging the settlement of asset protection trusts on jurisdictions like the Cook Islands I expect the number of jurisdictions with such laws to multiply. I also expect substantial competition between jurisdictions to continue. The tension for the jurisdictions is between maintaining respect in the family of nations and making its laws the most liberal in order to attract the most business. In addition, all jurisdictions are worried about attracting drug money. The jurisdictions do not want dirty money in large part because of the meddling from the United States and other countries which this also brings. *See,* Joseph, *Legislation Secret of Financial Success*, South China Morning Post Ltd., September 11, 1992 indicating that the success of the recent Cook Islands

provisions relevant to asset protection planning.[59] In addition, several jurisdictions which do not automatically recognize United States judgments, like the United Kingdom, the Netherlands or Ireland, may be appropriate in certain circumstances.[60] Sometimes fiscal reasons, usually resulting from tax treaties, may mandate the selection of a particular jurisdiction (e.g. the Netherlands Antilles).

The jurisdictions which have enacted or proposed specific legislation which may be relevant to an asset protection oriented trust are the Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Cyprus, Gibraltar, Guernsey, Isle of

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legislation is prompting many other independent states such as Madeira, Labuan in Malaysia, Mauritius in the Pacific and Belize in Central America to consider similar legislation (some of which has been enacted since this article, *see,* section II.B. *infra)*. *See also,* Goodman, *Cook Islands: Aims to stay Squeaky-Clean Tax Haven*, Reuters Financial Report, January 25, 1991 which points out that during 1990 the Cook Islands received $900,000 in various types of registration fees.

[59] Jurisdictions with asset protection oriented legislation are competing with each other for business. Each of the jurisdictions mentioned herein has, since 1989, either amended its laws or taken steps which evidence an intention to consider doing so. Further, I expect this field of practice, which is relatively unknown in the United States, to grow. For example, in the 1992 Martindale Hubbell only two lawyers in the United States listed a concentration in asset protection law. In the 1993 Martindale Hubbell there are 197 such listings (some of which are duplicates). Many of these attorneys with an asset protection concentration are centered in Colorado, Southern California (Orange County) and Florida. There are none listed, although some exist, in New York, Chicago and Los Angeles.

[60] The circumstances under which a United Kingdom trust might be appropriate exist when the settlor has no significant likelihood of incurring significant unsatisfiable debt or being engaged in litigation and desires the stability and respectability of a United Kingdom settled trust. Note, even in higher risk situations it may be appropriate to interpose as an intermediary a trust or other entity settled in a highly "respectable" and "established" jurisdiction which does not permit the automatic enforcement of United States judgements. Note that in the United Kingdom it is possible for a foreign individual to establish specific type of trust known as a "London" trust which, if properly settled, is not taxed.

Mann, Jersey, Labuan, Liechtenstein, Madeira, Mauritius, the Turks and Caicos Islands and Western Samoa. As mentioned above there are numerous other jurisdictions which may be appropriate in certain circumstances (e.g. the United Kingdom or the Netherlands Antilles). An in depth listing of jurisdictions or a through review of jurisdiction selection issues is beyond the scope of this article. The most popular jurisdictions for the settlement of asset protection trusts seem to be the Bahamas, the Cayman Islands, the Cook Islands, Gibraltar, and the Turks and Caicos. A brief status report on each jurisdiction follows. Following this is a detailed discussion of the legislation in the Cook Islands. For the purposes of the analysis in section III the author assumes that the trust is formed in the Cook Islands. A copy of the Cook Islands International Trusts Act 1984 as amended in 1985, 1989 and 1991 ("Cook Act") is included as appendix A.

1. Bahamas The Bahamas enacted the Fraudulent Dispositions Act, 1991 effective April 5, 1991. This act, sometimes referred to as the "Two Year Trust Act"[61] because of its two year statute of limitations[62] which begins to run from the date of the transfer, is referred to in a government sponsored publication as "a bold package of new financial laws aimed at winning back customers lost to rival offshore jurisdictions and attracting those seeking a safe haven for investing, depositing or protecting their assets."[63] The Fraudulent Dispositions Act provides that

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[61] *See, Specialized Portfolio on Swiss Bank Leu*, South China Morning Post, November 3, 1992, page 4.

[62] Section 3.-(3) of the Fraudulent Dispositions Act, 1991 provides in pertinent part: "[n]o action or proceedings shall be commenced pursuant to this Act unless commenced within two years of the date of the relevant disposition."

[63] Quickel, *The Bahamas: On Course to the Top*, Institutional Investor, September 1991, page 2.

"every disposition of property with an intent to defraud and at an undervalue shall be voidable at the instance of a creditor thereby prejudiced."[64] The fraud must be "wilful..."[65] the undervaluation must be "significant..."[66] and the burden of proof is on the creditor.[67]

The Bahamas has a strong secrecy law found in section 10 of the Bank and Trust Companies Regulation Act of 1965, as amended. This section provides in pertinent part that "No person who has acquired information in his capacity as...director, officer, employee...agent...counsel and attorney...auditor...[or] inspector...shall, without the express or implied consent of the customer concerned, disclose to any person any such information relating to the identity, assets, liabilities, transactions, accounts or a customer except...when a licensee is lawfully required to make disclosure by any court of competent jurisdiction within the Bahamas...." This section provides further that "Every person who contravenes the...[above provision] shall be guilty of an offense against this Act and shall be liable on summary conviction to a fine not exceeding fifteen thousand dollars or to a term of imprisonment not exceeding 2 years or to both such fine or imprisonment." An application pursuant to a letters rogatory process is required to implement this process. In connection therewith The (Evidence) Proceedings in the Foreign Jurisdiction Act, 1976 will only permit the production of evidence in criminal matters and then only after the "institution" of proceedings. Further, the author

[64] Fraudulent Dispositions Act section 4.-(1).

[65] Fraudulent Dispositions Act section 2.

[66] Fraudulent Dispositions Act section 2.

[67] Fraudulent Dispositions Act section 4.-(2).

understands that the Bahamanian central bank reports "large transactions" unless the customers have an "existing relationship" with a bank or are recommended by "reputable" parties.

The services of experienced and excellent trustees are readily available in the Bahamas. It, like a number of Caribbean jurisdictions, is readily accessible via convenient transportation and communication links. Accessibility is not always a desirable characteristic for a jurisdiction.

2. Barbados The Offshore Banking International Trust Committee is presently reviewing the Trustee Act 1979 with a view toward making the jurisdiction more attractive to foreign trusts. No specific asset protection oriented legislation has been enacted at the present time.

3. Belize Belize, formerly British Honduras, officially promotes the establishment of offshore asset protection trusts. It gained its independence from the United Kingdom in 1981 and has a judicial system based on that of the United Kingdom. English is the principal language and the country allows unrestricted inflow and outflow of capital.[68] As of 1992 Belize was serviced by four Banks (two of which were international) and had 350 registered foreign companies.[69] It just commenced the registration of trusts in late 1992.

The Belize Trust Act was enacted in 1992. This is a comprehensive act which in section (6) provides that "the Court shall not vary [a trust settled under Belize law]...or set it aside or recognize the validity of any claim against the trust property pursuant to the law of another

[68] *See, Belize Economy; New Policies for Diversification*, Institutional Investor, March 1993, page 2.

[69] *See, Survey of Belize*, Financial Times, September 22, 1992, page 32.

jurisdiction or the order of a court of another jurisdiction...over claims of creditors in an insolvency."

4. Bermuda Bermuda has enacted The Trusts (Special Provisions) Act 1989 which became effective January 31, 1990. Section 11 of this Act provides in part that where "a trust is validly created under the law of Bermuda the Court shall not vary it or set it asidepursuant to the law of another jurisdiction in respect of...the protection of creditors in matters of insolvency...unless the law of Bermuda has corresponding laws or public policy rules." This Act also permits a schedule of statutory boilerplate to be easily incorporated into a trust by a simple reference. Bermuda like a number of its neighbors has a substantial history of professionally dealing with offshore trusts. Normally, a Bermuda court will not assume jurisdiction to enforce a judgment against the United States settlor of an asset protection trust unless the settlor is resident in Bermuda. Bermuda permits the formation of private trust companies to serve as trustee of an asset protection trust. The stock of this company may be owned by the settlor's family members or a trust set up for this purpose. It is thought that by using private trust companies the settlor has firmer control without actually holding the power to remove and appoint trustees. As a condition to forming a private trust company the names and addresses of its beneficial owners must be disclosed to the Bermuda Monetary Authority which treats such information as confidential.

5. British Virgin Islands The Financial Review Committee is currently reviewing a proposed act entitled "The Fraudulent Dispositions and Validity of Settlements Act, 1992" which, upon approval, will be submitted to the Attorney General for drafting into final form for submission to the Legislature. The British Virgin Islands, which currently follows common law

rules for the regulation of trusts, with its history of financial and political stability is even now a very desirable situs for asset protection trusts even though its laws do and will provide less protection from direct attack than certain other jurisdiction. As a matter of interest, British Virgin Island corporations are often preferred when a corporate entity is required since they can be formed relatively quickly and cheaply. Bearer shares are permissible, thus permitting strict confidentiality.

6. Cayman Islands The Cayman Islands has enacted The Fraudulent Disposition Law, 1989, effective May 1, 1990, which replaced the Statute of Elizabeth. This law is not nearly as liberal as many other jurisdictions in that it has a six year statute of limitations and provides at section 4.(1) that "every disposition of property made with an intent to defraud and at an undervalue shall be voidable at the instance of a creditor thereby prejudiced." The law only protects creditors who were in existence at the time of the transfer. Unanticipated future creditors are not protected by the Cayman law.[70] The burden of proving the willful intent of the transferor is on the creditor.[71] Suit can only be brought by a creditor on behalf of himself. A Cayman court will not recognize a suit brought by a trustee in bankruptcy on behalf of all creditors.

A trust on the Cayman Islands settled without local resident beneficiaries may register as an "exempted trust."[72] An exempted trust is granted a fifty year tax holiday. The law permits

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[70] Fraudulent Disposition Law section 4.

[71] Fraudulent Dispositions Law section 4.(2).

[72] *See,* Trusts (Foreign Element) Law, 1987.

substantial flexibility, including a fixed perpetuity period or up to 100 years, provided the trust is submitted to the Registrar for advance approval. In addition, Cayman law permits the selection of Cayman law in the trust instrument even though neither the settlor, the trust property nor the trustees have any connection with the Cayman Islands.[73] If Cayman law is selected, the trust cannot be voided on the ground that it contravenes the laws of another jurisdiction (including forced heirship laws), including the domicile of the settlor, or is not recognized by the law of another jurisdiction (e.g. purpose trusts).

Despite the less favorable trust law and despite the fact that a comprehensive review of trust legislation is currently in process, the Cayman Islands remains one of the favored jurisdictions for the settlement of asset protection trusts. The Cayman Islands, like the Bahamas, has strong secrecy laws.[74]

The Cayman Islands boast a very strong banking presence. Grand Cayman has 538 Banks which hold over $430 billion in deposits. By way of comparison, that makes Grand Cayman one of the world's ten biggest financial centers, comparable to London, New York and Tokyo.[75]

7. Cook Islands See section II.C. of this article.

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[73] *See,* Trusts (Foreign Element) Law, 1987.

[74] *See,* Bank and Trust Companies Regulation Law, 1966 and Confidential Relationships (Preservations) Law, 1976.

[75] *See,* Gartland, *International Tax Havens become less Hospitable for the Pirates*, London Times, June 12, 1992, (Business Section) [hereinafter Gartland].

8. Cyprus The Cyprus House of Representatives passed The International Trusts Law in July of 1992. This law provides a comprehensive set of laws regulating the registration of international trusts and is unique in that it does not require the registration of an "international trust." The only amount payable to Cyprus is $500 upon settlement of the trust in the form of a stamp duty. The International Trust Act does not override the Statute of Elizabeth but, instead, closely parallels United Kingdom trust law. It is a popular base for companies driven out of Eastern Europe or Lebanon notwithstanding the division of the island into Greek and Turkish Cypriot sectors separated by United Nations peacekeepers. Cyprus has a tendency to regulate offshore companies heavily, for example, by requiring submission of an audited financial report every year. In addition, according to Mr. Sophocles Nichaelides of the central bank, "We're not a tax haven; we're offering tax incentives." It is unclear what regulations or taxes may be imposed upon offshore trusts.[76]

9. Gibraltar Gibraltar, known as "the Rock," has a trust law based on the English Trustee Ordinance 1893 which was enacted in Gibraltar. Recently the English Variation of Trusts Act 1988 was incorporated into Gibraltar statutory law.

Gibraltar recently enacted the Bankruptcy (Amendment) Ordinance 1990 which protects certain "registered settlements." This Act provides that certain dispositions by solvent settlors who are unaware (i.e. does not have actual notice) of any impending legal action at the time of settlement are not "voidable at the instance of or upon application by any creditor of the settlor."

[76] Hope, *Survey of Republic of Cyprus*, The Financial Times, March 23, 1992, page III.

The Act also protects a settlor provided he is not "insolvent on the date of the transfer" and the transfer does not render him insolvent.

For a settlor to avail himself of the protection of the Bankruptcy (Amendment) Ordinance 1990 each transfer to the trust must be registered.[77] Prior or subsequent unregistered transfers are not protected by this Act. Registration of settlements is regulated by the Bankruptcy (Register Dispositions) Regulation (99v) which permit registration only if:

1. Disclosure forms approved by the Financial Development Secretary have been completed by the settlor and approved by the trustee;
2. The trustee has reviewed the public records to substantiate the disclosures;
3. The settlor has executed an affidavit of solvency; and
4. The trustee is in compliance with the licensing requirements of the Financial Services Ordinance 1989.

The provisions in Gibraltar are attractive to many settlors because they permit the equivalent of an "advance ruling" prior to committing the actual transfer to the trust. Gibraltar is well served by the banking and trust industry. Currently it has 29[78] banks with more than Pounds 2 billion in deposits.[79]

10. Guernsey The Trusts (Guernsey) Law 1989 modernized Guernsey trust law and specifically authorized the use of spendthrift trusts and protectors. The legislature was recently

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[77] Bankruptcy (Amendment) Ordinance 1990 section 42.

[78] Rankine, *European Business: Gibraltar tries to shrug off past*, The Daily Telegraph, February 1, 1993, page 23.

[79] Gartland, *supra*.

presented with a modern fraudulent conveyance act, The Rights of Creditors (Guernsey) Law, 1992 which has not been enacted. Guernsey is a popular jurisdiction well served by the banking community with over Pounds 18 billion of deposits.[80]

Guernsey has an independent organization on the island known as the Financial Services Commission which exercises great influence. This organization is headed by Mr. John Roper. He recently gave an interview in which he made it clear that "he is keen to avoid the prospect of a U.S. judge hearing a court case and frowning when Guernsey is mentioned as 'one of those places' - some form of shady tax haven. He has sent a clear message recently that asset protection trusts should not be encouraged on the island...."[81]

11. Isle of Man One commentator characterizes the Isle of Man as the "most favored trust center for asset protection trusts aimed at creditors."[82] A recent Counsel of Ministers Report on trusts recommends that a provision insulating certain types of trusts settled by individuals solvent at the time of settlement be insulated from challenge. This has not yet been enacted. The Isle of Man, center of the BCCI failure, is unique in offshore trust centers in that it has a compensation scheme for bank deposits. For example, every depositor in the failed BCCI is able to claim Pounds 15,000 in compensation in a bailout which is costing each remaining bank on the island Pounds 750,000. This may account for part of this jurisdiction's popularity.

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[80] Gartland, *supra*.

[81] Jack, *Survey of Guernsey*, The Financial Times, March 31, 1993, page XIII.

[82] Duckworth, *The Offshore Trust in Transition*, International Estate Planning, 129, at 158 (ABA 1991). This is part of a worthwhile series of essays assembled by the American Bar Association.

12. Jersey On July 1, 1992 the governmental Financial Services Department announced it is considering trust administration and expects legislation by early 1994. Jersey does not apply the principles of chancery courts. It is well served by the banking community with over Pounds 45 billion in deposits.[83]

13. Labuan Labuan promotes itself as the only tax haven in the East Asian time zone. Its trust law is statutorily created and its courts do not follow the principles of chancery courts. Labuan is also far more accessible than the Cook Islands or other remote jurisdictions in the South Pacific because it is so close to Malaysia. It currently has nine banks and is in the final planning stages for a major international airport.[84]

14. Liechtenstein Liechtenstein is a civil law jurisdiction which has enacted a trust law. It has a one year statute of limitations for trusts settled without intent to harm creditors. It is well known for its secrecy laws[85] and currently, in its mutual fund business alone, controls more than Pounds 70 billion, "rather more" than the entire trust industry of the United Kingdom.[86] Recently Liechtenstein received some very bad publicity when it emerged that Robert Maxwell used a series of secret trusts in Liechtenstein to steal more than $450 million of pension money.[87]

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[83] *See,* Gartland, *supra*.

[84] Tan, *A Foreign Affair*, Business Times, February 6, 1993, page 5.

[85] One of Liechtenstein's competitors on Gibraltar characterizes Liechtenstein as the place "where you hide things." *See,* Burns, *Survey of European Offshore Centres*, The Financial Times, April 30, 1993, page II. This critical comment may have been generated when the trust industry on Gibraltar found out that a secret trust on in Liechtenstein owned the business which is privatizing Gibraltar's highly confidential company registrar.

[86] *See,* Gartland, *supra*.

[87] Cohen, *Survey of European Offshore Centres*, The Financial Times, April 30, 1993,

15. Madeira Madeira is an island off the Ivory Coast of Africa which is under the jurisdiction of Portugal. In the past Madeira has been primarily utilized as an situs for ship registration and tax favored manufacturing. The government has announced an intention to enact laws designed to promote foreign investment and trust settlement. A law specifically fostering asset protection trusts has not been proposed.[88]

16. Mauritius In 1989 Mauritius enacted a law cutting taxes to zero and lifting all exchange controls. Strict secrecy laws were also enacted. In June 1992 an Offshore Trusts Act was passed. Since 1988 seven foreign banks have launched offshore banking operations in Mauritius.[89] Mauritius is characterized as a stable and fiscally sound country. It has a population of 1 million, debt of $991 million and has never missed a debt payment.[90]

16. Turks and Caicos The Turks and Caicos Islands, a British Crown Colony approximately 600 miles southeast of Florida, is a popular jurisdiction for the settlement of asset protection trusts. It has recently enacted The Trusts Ordinance Act 1990 which specifically recognizes "Asset Protection Trusts." The Turks and Caicos Trust Ordinance Act provides that foreign laws are not to be considered in determining any questions relating to the viability of a trust registered on the Turks and Caicos.[91] It contains broad debtor protection provisions

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[88] *See,* Han, *European Finance and Investment, Offshore Centres 3; In Search of Fiscal Nomads*, The Financial Times, February 28, 1992, page II.

[89] *See,* Morna, *Offshore Sector*, The Institutional Investor, March 1993, page S6.

[90] *See.* Acworth, *Mauritius Strives to Become Offshore Bank for Africa*, The American Banker-Bond Buyer, January 25, 1993, Vol. 6, No. 3, page 5.

[91] Trust Ordinance Act section 13.

including authorization of spendthrift provisions [92] and a provision entitled "Asset Protection Trust"[93] which protects a settlor who was solvent when the disposition was made and does not become insolvent as a result of the disposition. The burden of proving insolvency is upon the creditor.[94] The settlor of a Turks and Caicos trust has a statutory right to include in the trust instrument clauses authorizing a change in the law governing the validity of the trust.[95] This section also contains a saving clause providing that such transfer cannot invalidate other terms of the trust and must be "consistent with the intention of the settlor."

17. Western Samoa In 1988 Western Samoa enacted the Off-Shore Banking Act and the International Companies Act of 1987. Under the international Companies Act, companies not doing business on Western Samoa are completely exempt from all taxes. The island state has strong secrecy laws and a history of stable government. At the current time there are six accountancy firms and eight law firms on the island. The government has announced an intention to actively promote international trust and company registration business.[96]

C. Cook Islands[97]

[92] Trust Ordinance Act section 34.

[93] Trust Ordinance Act section 61(1).

[94] Trust Ordinance Act section 61(2).

[95] Trust Ordinance Act section 40.

[96] *See, Tax Haven Established in Western Samoa to Attract Foreign Investors*, Xinhua News Service, August 1, 1989 and Porter, *Takeover Helps Bid to Enter Asia-Pacific Finance Market*, The South China Morning Post, September 11, 1992, page 1.

[97] I have received substantial and valuable assistance from two individuals heavily

The Cook Islands is a sovereign state located approximately 1800 miles north east of New Zealand. In 1965 the country became self governing in free association with New Zealand, with New Zealand retaining a responsibility for external affairs and defense. In practice, however, the Cook Islands conducts its own external affairs, its foreign policy differing from that of New Zealand in ways which reflect the particular needs and location of the country. The Cook Islands are free to establish complete independence at any time without the consent of New Zealand. The Cook Islands government has complete legislative and executive competence over all the nation's affairs, including exclusive power to amend the country's constitution.

The Cook Islands is a common law jurisdiction. Section 615 of the Cook Islands Act 1915 provides (*inter alia*) that the law of England as existing on 14 January 1840 shall be in force in the Cook Islands, and on this basis the High Court of the Cook Islands - which is a Court with full legal and equitable jurisdiction - views English and Commonwealth case law as persuasive precedent. The Cook Islands thus recognizes the equitable concept of a trust, and the large body of applicable English and Commonwealth case law. That case law has been modified by the Trustee Act 1956 (which is loosely modeled on the United Kingdom Trustee Act 1925) and, in the case of asset protection trusts, by the Cook Act.

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involved with the trust industry on the Cook Islands. Timothy Paul Arnold, Partner in Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands has reviewed the general material on the Cook Islands law and legal system and provided very helpful input. Stephen B. Breed, Chief Executive, International Trust Corporation Limited, Rarotonga, Cook Islands (as well as Hong Kong and the British Virgin Islands) has reviewed all the materials on Cook Islands trusts and has likewise provided helpful comments and valuable input, particularly with reference to trust company practices and procedures.

The Cook Act provides extensive creditor protection and transfer provisions; these are considered in detail below. Furthermore, an international trust established under the Cook Act is wholly exempt form all forms of Cook Islands taxation.[98]

The Cook Act contains a number of provisions which substantially modify the pre-existing law which are of interest to estate planners but have nothing to do with asset protection. The relevant provisions are section 6 (establishment of a specific and liberal perpetuity period), section 7 (adoption of the wait and see doctrine), section 8 (abolition of the rule against double possibilities), section 9 (application of the rule against accumulations) and section 10 application of the rule in *Saunders v. Vautier*).

The Cook Act also contains a number of provisions which are relevant to this jurisdiction's desirability as the situs for a trust specifically designed for enhanced asset protection. These are as follows:

1. Anti Statute of Elizabeth provision: The Statute of Elizabeth made it possible to set aside a transfer that was intended to defeat future - but currently unknown - creditors.[99] It is the

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[98] Cook Act section 21.

[99] The actual Statute of Elizabeth, which was enacted by the English Parliament in 1571 and originally called "An Act Against Fraudulent Deeds, Alienations, & Etcetera" was the precursor to all later enacted fraudulent conveyance acts. It is interesting because, prior to the enactment of the Statute of Elizabeth, it was common to hide from creditors in certain areas of safety called "precincts.". Apparently the practice was so widespread that Parliament stated this fraud is "more commonly used and practiced in these days then hath been seen or heard of before." (Paragraph I). The statute states that without the legislation "no commonwealth or civil society can be maintained or continue." (Paragraph I) Finally, it is interesting to note that this law, like many, had a fiscal purpose: one half of the recovery went to the defrauded creditor (Paragraph III(7)) and one half went to the "Queen's majesty." (Paragraph III(7)). The debtor also went to jail for "one half year without bail." (Paragraph III(8)). 13 Elizabeth I Ch. 5 (1571).

precursor to all fraudulent conveyance acts. The Cook Act[100] specifically overrides this by providing that the trust "shall not be fraudulent as against a creditor of a settlor if the settlement...took place before that creditor's cause of action...had arisen." Just to make sure, section 6 of the International Trust Amendment Act of 1991 provides:"*Repeals* - The enactment titled, 13 Elizabeth I Ch 5 (1571) shall have no application to any settlement upon or disposition to an international trust."

2. Cook fraudulent settlement law: If the establishment of an "international trust"[101] is done with the "principal intent to defraud" a particular creditor and this renders the settlor insolvent, then that specific creditor by bringing suit on the Cook Islands can be recompensed out of the trust (provided there still is a trust and the assets have not been transferred out of the Cook Islands).[102] Neither the transfer to the trust nor the trust itself is invalidated by the Cook Act. As a result each creditor must bring his or her own action. The standard of proof which the aggrieved creditor must meet is "beyond a reasonable doubt."[103] There have been "several"..."a very small number" of actions brought under this portion of the Cook Act and no case has ever got to the merits, being settled or disposed of under the procedural grounds discussed herein.[104]

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[100] *See,* Cook Act section 13B(4).

[101] This is simply a trust registered with the Cook Islands as an "international trust" in accordance with the Cook Act.

[102] *See,* sections I.D.8(b) *supra* and II.B.5. and III.B.6. *infra* discussing Cuba clauses.

[103] Cook Act section 13B(1).

[104] This is confirmed by Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Island. The Cook Act states that it shall be an "offense...to divulge to any other person information relating to the establishment...or affairs of an international trust."

Section 13B(5) of the Cook Act provides a large number of traditional "badges of fraud"[105] of the settlor which "solely by reason of which" "shall not" permit an inference of fraud. Such actions[106] include settlement of the trust,[107] naming the settlor as a beneficiary,[108] retaining a power to amend[109] or to revoke[110] or to remove a trustee[111] or to direct a trustee.[112]

3. Statute of limitations: Both the "international trust" and the actual transfer to the trust shall conclusively be presumed to not be fraudulent if (1) two years has passed since the creditor's cause of action accrued (i.e. as that phrase is defined in section 13B(8)[113] of the Cook Act) or (2) in the event that the "international trust" was established prior to the expiration of the 2 year statute of limitations mentioned in (1) above, then the creditor's action was commenced in the Cook Islands more than one year after of the establishment of the trust or the transfer to the

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Section 23. This offense bears criminal sanctions including imprisonment "for a term not exceeding 1 year" or a fine of up to $10,000. Lawyers, bankers, accountants, trust officers and all others involved in asset protection planning take this secrecy requirement very seriously which is one reason why there is very little reliable information on asset protection planning. *See,* section II.C.7. *infra*.

[105] *See,* section I.B. *supra*.

[106] For tax and debtor creditor reasons the settlor would not wish to exercise many of these powers. *See,* sections I.D.2. *supra* and IV. *infra*.

[107] Cook Act section 13B(5)(a).

[108] Cook Act section 13B(5)(c).

[109] Cook Act section 13C(c).

[110] Cook Act section 13(C)(a).

[111] Cook Act section 13(C)(e).

[112] Cook Act section 13C(g).

trust.[114] This has the effect of imposing a one year statute of limitations if a transfer is made to an "international trust." The Cook Act is very specific as to the date on which the statute of limitations begins to run. In all cases the statute of limitations begins to run on the date of the first act or omission that generated the claim.[115] This is particularly harsh in the case of an action upon a judgment, as most actions from the United States would be.[116] In that case the statute begins running on "the date that the omission shall have first occurred, as the case may be, which gave rise to the judgment itself." In almost every case, by the time the judgment is obtained the statute of limitations in the Cook Islands will have run.[117]

4. Bankruptcy: The Cook Act provides that an "international trust," even if "voluntary and without valuable consideration" or made "for the benefit of the settlor" shall be deemed "valid" and shall not be void or voidable by the settlor's bankruptcy or insolvency. The Cook Islands does not have any laws relating to bankruptcy and bankruptcy will not invalidate a trust settled in the Cook Islands. In particular, the Cook Act provides "In determining the existence

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[113] See appendix A.

[114] Cook Act section 13B(3).

[115] Cook Act section 13B(8).

[116] Notwithstanding the automatic stay of Bankruptcy Code Section 362, I believe that a bankruptcy judge would quickly grant permission for suit to be brought in the Cook Islands. However, a more practical question is whether any attorneys representing the debtor (and indeed, the United States Trustee) would even think of this issue until the statute of limitations had run. First, they have to discover the existence of the trust which can take some time. Next they have to get a copy of the Cook Island law, which can take some time. Even if they do pursue the assets in a timely manner the mere request of information and certainly the filing of a suit on the Cook Islands could trigger the Cuba clause and other duress provisions. *See,* section III.B. *infra*.

[117] *See,* Cook Act section 13B(8)(b) and section III.B.4. *infra*.

and validity of a trust registered under this Act the Court shall apply: (a) the provisions of this Act; and (b) any other law of the Cook Islands; and (c) and other law, which would be applied; if to do so, would validate the trust."[118]

Two sections of the Cook Act take this even further by specifically providing that Cook Island law shall govern matters relating to the validity of the trust and specifically excluding the application of foreign law if such law could somehow negatively impact either the existence of a Cook Island trust or its ability to hold property or otherwise transact business.[119]

5. Flight provisions: The Cook Act specifically contemplates a change of governing law and hence trust situs. The Cook Act validates a change if, "in the case of a change to the law of the Cook Islands, such change is recognized by the law of the trust previously in effect; [and] in the case of a change from the law of the Cook Islands, the new governing law would recognize the validity of the trust and the respective interests of the beneficiaries."[120]

6. Enforcement of foreign judgments: "Notwithstanding...the provision of any...treaty...statute...[or a]ny rule of law, or equity...no proceeding for or in relation to the enforcement...of a judgment obtained in a jurisdiction other than the Cook Islands against ...[a] trust, settlor...[or] trustee...shall be entertained...in the Cook Islands if...[t]hat judgment relates to

[118] Cook Act section 5(3).

[119] Cook Act sections 13H and 13I.

[120] Cook Act sections 13G(4)(i) and (ii).

a matter...that is governed by the law of the Cook Islands."[121] As a result, all foreign judgments must be relitigated *de novo* in the Cook Islands.

7. Secrecy: All judicial proceedings relating to a Cook Islands trust are to be *in camera* and no details may be published without an order from a Cook Islands court.[122] Although not specifically stated in the Cook Act, no details of the trust need be filed with or disclosed to any public agency.[123] Any violation of this provision, as well as all other provisions of the Cook Act, is a criminal matter calling for a fine of up to US$10,000 as well as up to one year in jail.[124]

8. Registration: The Cook Act provides for the registration of international trusts. An international trust is simply a trust or disposition which is registered as such under the Cook Act. In order to qualify for registration an international trust must have at least one trustee (or in the case of a disposition, one of the donors or holders of the power of appointment, maintenance or advancement) which is registered in the Cook Islands as a foreign company or an international company (*i.e.,* companies registered or incorporated in the Cook Islands which are typically controlled by or on behalf of the settlor) or a trust company. In practice, the trust companies

[121] Cook Act section 13D.

[122] Cook Act section 23.

[123] Neither an attorney nor a trustee on the Cook Islands will disclose any information. This penchant for secrecy is taken very seriously. For instance, several trust advisors have told me that they who will not even come into the United States for more than a few days at a time to avoid establishing a "presence" here which might somehow make them subject to long arm statutes or somehow expose their clients to discovery supervised by a United States court. See, section II.C.2 *supra*.

[124] Cook Act section 28.

established in the Cook Islands will provide such a trustee on request subject to indemnity requirements.

Registration of an international trust is a straightforward process which entails retaining the services of a trust company in the Cook Islands. There are currently five trustee companies on the Cook Islands and fees do vary widely (from about $1,350 to about $5,000) for registration and the first year's administration. The fee routinely includes the registration charge of the Government (currently $100.00 *per annum*) but does not include special charges (typically $80.00 to $200.00 per hour) if substantial or specialized administrative work is required (*e.g.,* when a duress provision is triggered).

The trustee company will require the provision of information to satisfy itself that the international trust is not being registered for criminal or fraudulent purposes. A certificate or affidavit of solvency will be required and a deed of indemnity from the client will be sought routinely. The trustee company will provide the registered office in the Cook Islands for the international trust and will attend to annual re-registration, accept service of process and generally provide the Cook Islands *locus* for the international trust.

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SECTION III

III. HOW TO ATTACK AN ASSET PROTECTION TRUST

This section of the article will analyze the various techniques available to attack the assets of an asset protection trust. This section, via a hypothetical, first analyzes an attack in the United States courts and then abroad in a jurisdiction assumed, for the sake of discussion, to be the Cook Islands.

A. United States Courts

1. The "Old and Cold" asset protection trust

Hypothetical 1

> The settlor of our hypothetical trust currently is a surgical resident in New York. In 1985 he inherited $8 million of high grade tax free municipal bonds. He has never touched his principal or interest. He has no debts at all except current living expenses such as his telephone and electricity and one credit card, which he pays off each month. The settlor is currently unmarried but is engaged. His fiance does not know of the invested funds, now worth substantially more than $12 Million dollars. Assume in 1993 Settlor establishes an asset protection trust in the Cook Islands. The money is kept invested in the same class of mutual bonds with major New York bank serving as custodian and holding the bonds for the trust's account under a street name. The settlor, his attorney and a foreign attorney compose the Committee of Trust Advisors. Assume further that the settlor gets married later in 1993 and finishes his surgical residency. He opens an orthopaedic surgery practice in New York specializing in sports medicine. By 1999 he has his own operating suite at his office on Park Avenue.
>
> **The settlor's first big mistake:** He works hard and builds a good practice. He has bought a house in Westchester and by 1999 has two small children, a nanny (illegal), a full time maid (also illegal), 6 secretaries and nurses (legal) and a poolman (part-time). He is netting $800,000 to $900,000 per year, working 16 hour days. So far, he has no financial problems, his marriage is rocky and he

"drinks a little." Assume further that a principal ballet dancer for the New York City Ballet ("the judgment creditor") has developed arthritis of his hip and comes in to the settlor for what is by then routine hip replacement surgery. On the night before the surgery, January 3, 2000, the settlor has a terrible fight with his wife. He leaves home, calls the Athletic Club to book a room and, after he arrives, pours himself into a bottle. The next day after breakfast and "a small bite of the dog that bit me" he walks to his own hip replacement facility, drunk but able to hide it. He does the surgery on the wrong hip, it gets infected and ten days later the wrong leg has to be amputated at the hip. Finally, assume that the settlor is sued and four years later on January 3, 2004, the judgment debtor receives a judgment of $25,000,000, one million of which is covered by the settlor's errors and omissions insurance. At the time of the judgment the only United States situs assets of the settlor are small accounts receivable, the equity in his house and a four unit apartment house owned by a family limited partnership. Immediately after the judgment the settlor's medical license is revoked.

Analysis:

In hypothetical 1 we have a situation where the settlor of the asset protection trust has committed a grievous tort, has a substantial judgment against him personally and adequate funds

in his asset protection trust to satisfy a major portion of the judgment. The trust is "old and cold," all formalities have been observed and the trust was settled with a transfer which is clearly not fraudulent.

(a) Discovering the trust - State Courts:

The judgment creditor, through his highly motivated lawyers, will immediately proceed to execute upon the judgment.[125] One of the first things that the judgment creditor's attorneys will do as part of this collection process[126] is to compel a debtor's examination under state law.[127] At this examination the judgment creditor's attorneys will possibly, but not definitely, depending on their experience and motivation (often the least experienced attorneys are given this ignoble job), ask a question which would require the settlor to disclose the 11 year old asset protection trust in which he is nothing but a "mere remainderman." The settlor has not and should not under generally accepted accounting principles put his contingent remainderman's interest on his financial statements. By this time, if the settlor has only gotten "blind accountings" he may not even know where the assets are situated or what they specifically are. Often an attorney conducting a debtor's exam will focus on tracking assets and totally miss the big picture.

We will assume that the attorney conducting the exam was able to discover the asset protection trust. Further, the settlor's attorney, in furtherance of his responsibilities as a Member

[125] *See,* Debtor Creditor Law chapter 37.

[126] *See,* Debtor Creditor Law chapter 37.

[127] The law is similar in most States. *See,* New York C.P.L.R. section 5101 *et seq.*.

of the Committee of Trust Advisors (aka "Protectors") has already notified the trustee in the Cook Islands of the judgment which automatically triggered the duress provisions of the trust.[128] Even if the settlor's attorney did not notify the trustee, all that it would take to possibly trigger the duress provisions is a call or letter from the judgment creditor's attorneys to the Cook Islands trustee requesting information.[129] When this happens, because of the duress provisions the settlor's attorney drafted 11 years before, the settlor's attorney and the settlor were probably removed from the Committee of Trust Advisors, and the New York bank acting as custodian was instructed by the trustee in the Cook Islands to immediately transfer the entire portfolio to a different institutional custodian outside of the jurisdiction of the United States courts.[130] The assets were then most likely placed in a blind trust custodial arrangement with a major bank in some other stable jurisdiction comparable to New York.[131] Neither the settlor nor his attorney will be told where the assets are or how they are held. Finally, the trustee knows that any instructions from the settlor or his attorney delivered pursuant to a court order are to be disregarded.

(b) Seizing non-trust United States situs assets

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[128] See sections I.D.8 *supra* and III.B. *infra*.

[129] See section I.B.8. *supra*.

[130] The Cook Islands currently has satellite offices of at least 6 major banks.

[131] If the Cook Islands trustee puts the assets in Switzerland and you are somehow able to find out this fact you may be able to seize them under the special *Attachment* provision in the Swiss code. *See,* section III.A.3(h)(ii) *infra*.

(i) Traditional court ordered execution: The United States situs house, accounts receivable and personal property, to the extent that they are not exempt from execution,[132] have been seized. The proceeds from these assets are inadequate to satisfy the judgment.

(ii) Charging order - the family limited partnership:[133] The settlor and his wife have a family limited partnership. This was included in the hypothetical because the use of a family limited partnership is a popular way to turn attractive assets (i.e. an apartment house) into unattractive assets. It is also a technique whereby the asset protection trust may own U.S. situs assets. The asset becomes unattractive to a creditor because, by placing the apartmenthouse into the limited partnership the judgment creditor's remedy changes. The judgment creditor cannot execute directly upon the apartment house and force its sale. Instead, the remedy is outlined by the Uniform Limited Partnership Act which provides that "On application to a court...by a judgment creditor, the court may charge the partnership interest of the partner with payment of the judgment...[T]he judgment creditor has only the rights of an assignee of the partnership interest."[134] This act also provides that "An assignment entitles the assignee to receive...only the distribution to which the assignor would be entitled."[135]

The drafters of the Uniform Limited Partnership Act inserted this charging order concept into the act to prevent the creditors of a partner from disrupting the partnership business. However, these same provisions can be utilized in the family limited partnership context to prevent the

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[132] *See,* Debtor Creditor Law section 37.03.

[133] *See,* Debtor Creditor Law section 37.03[A][7].

[134] U.L.P.A. section 703.

distribution of funds to the judgment creditor. This is because under relevant partnership law the general partner,[136] who is likely to be a family member or a corporation controlled by family members, can prevent distributions. The Internal Revenue Service has also held in Revenue Ruling 77-137[137] that the creditor with a charging order is treated as a substituted limited partner for tax purposes. As a result the judgment creditor is saddled with the tax consequences resulting from ownership without the capacity to force dissolution of the partnership or distributions from the partnership.[138]

The asset protection trust is sometimes positioned as a limited partner. Care should be taken to make sure that the asset protection trust does nothing to potentially avail itself of the jurisdiction of any United States court. It is the author's opinion that the asset protection trust should never be the general partner of a limited partnership because to do so runs the risk of subjecting the asset protection trust to the jurisdiction of a United States court. It is always preferable that the asset protection trust own no United States situs assets.

(c) Attacks against the offshore trust - State Courts

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[135] U.L.P.A. section 702.

[136] The general partner should never be the settlor of the trust because it is possible that a judgement creditor could then dissolve the partnership and force distribution of the assets. *See,* Henkel, *How Family Limited Partnerships Can Protect Assets*, 20 Estate Planning 3 (1993).

[137] Rev. Rul. 77-137, 1977-1 C.B. 178.

[138] The California courts have departed from the charging order provisions in the Uniform Limited Partnership Act and permitted actual attachment and sale of a partnership interest provided that this does not disrupt the business of the partnership. *See, Crocker National Bank v. Jon R. Perroton* 208 Cal. App. 3d 1; 255 Cal. Rptr. 794 (1989). Disagreed with by the court in *Hellman v. Anderson* 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (3d Dist. 1991)

The judgment debtor's attorneys first tried to satisfy the judgment from traditional United States situs assets. After that failed and the attorneys for the judgment debtor heard of the trust the judgment creditor's attorneys had their expectations rise since there was a substantial sum to satisfy the judgment. It is likely that the attorneys for the judgment creditor went through the following analysis:

(d) Attaching Debtor's reversionary interest: Does the settlor have a sufficient interest in the trust to enable it to be attached? The simple answer is that he does not. The trust has been carefully crafted to avoid exposure, even if it were a domestic trust, on these grounds. The settlor does not have a sufficient interest in the trust to make it reachable. The settlor is a "mere remainderman."[139]

With respect to this issue in a bankruptcy proceeding, the settlor might advance an argument pursuant to section 541 of the Bankruptcy Code that the trust proceeds are not properly included in the estate. This section provides in pertinent part that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable under this title." The United States Supreme Court has recently held that "applicable nonbankruptcy law" includes both state law (e.g. spendthrift clauses) and federal law (e.g. ERISA - qualified pension plans including anti-alienation provisions).[140] The Court did not decide whether this phrase encompasses the laws of foreign countries, such as England, France and the Cook Islands. This type of analysis often comes up when courts in the United States are

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[139] *See,* Debtor Creditor Law section 37.03[A].

[140] *Patterson v. Shumate* 112 S. Ct. 2242, 119 L. Ed. 2d 519, 60 U.S.L.W. 4550 (1992) *reh'g denied* 120 L. Ed. 2d 940, 113 S. Ct. 13, 61 U.S.L.W. 3149 (1992).

called upon to enforce judgments obtained in other countries. Traditionally, United States courts respect the laws of foreign jurisdictions even if such laws appear to violate certain of our fundamental rights.[141]

(e) Attacking the "Old and Cold" transfer as fraudulent: If the settlor's interest in the trust cannot be attacked, can the transfer to the trust be set aside as a fraudulent conveyance? New York law would apply and, in the instant case, this eleven year old transfer made at a time when the settlor had no debts and more than adequate income to meet his needs was clearly not fraudulent. Most courts would have no alternative but to hold that the original settlement of the asset protection trust was not fraudulent and that the trust was worthy of respect, particularly if the business justifications for the trust[142] were emphasized in the documentation. Further, even if a United States court were to find the transfer fraudulent it is unlikely that the judgment creditor could reach them.[143] Under the facts of this hypothetical, the poor judgment creditor will likely spend the rest of his life attempting to garnish the wages of an unemployable alcoholic former doctor.

Until the asset protection trust terminates and proceeds are distributed to the settlor, the judgment creditor does not have any significant assets to attach. Even upon distribution, the judgment creditor will only be able to attach the assets if (1) he knows where they are and (2)

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[141] *See, Somportex Limited v. Philadelphia Chewing Gum Corporation*, 453 F.2d 435 (3rd cir. 1971), *cert. denied* 405 U.S. 1017, 92 S.Ct. 1294, 31 L.Ed.2d 479 (1972) in which a United States court enforced a judgement from an English court against a United States company which would have violated the defendant's due process rights if the case had been tried in the United States. *See,* Lowenfeld, *supra*.

[142] *See,* section I.C. *supra*.

[143] *See,* section III.A.3. *infra*.

they are subject to the jurisdiction of a court which will enforce his judgment.[144] Finally, the judgment creditor might make an effort to reach other assets (i.e. the errors and omissions policy and personal assets of the settlor's attorney). These attacks are unlikely to be successful provided the transfer to the trust was not fraudulent.[145]

2. The Pre-nuptial asset protection trust

Hypothetical 2

Assume at the time of the debtors examination, the settlor's wife discovers that the alcoholic former doctor that she is married to has a great deal of money that he has been hiding from her. This infuriates her and she files for divorce.

The settlor's soon to be former spouse does not stand in any better position than the injured judgment creditor. Even if she were to get a judgment against the settlor for a portion of the assets held in the Cook Islands she can not enforce it.[146] The only potential difference is that child support and alimony obligations are not dischargeable in bankruptcy[147] and sometimes courts will use their contempt power to endeavor to enforce these obligations.[148] The only reason to include this hypothetical is to point out that an asset protection trust can often achieve the

[144] In order for the assets to be safely distributed to the settlor the settlor may have to take certain extraordinary steps. The judgement debtor might move abroad (perhaps to one of the many places like Monaco where the judgement will not be automatically recognized and there are no income taxes) and perhaps even expatriate. On occasion expatriation, if carefully managed, can produce a substantial tax savings. *See,* I.R.C. Section 877.

[145] *See,* section III.A.3(e) *infra*.

[146] *See,* section III.B. *infra*.

[147] *See,* Bankruptcy Code section 523.

[148] *See,* Section III.A.3(d) *infra*.

same result as a pre-nuptial agreement except that the prospective spouse with the money does not have to obtain the agreement of the other prospective spouse.

3. Trust settled with fraudulent conveyance -

Hypothetical 3

This hypothetical assumes that the asset protection trust was settled in the weeks immediately following the surgery and after the malpractice action was filed. The sole purpose of the trust was to put assets out of the reach of the probable judgment creditor. The transfer to the trust is fraudulent on its face under both state and Federal Bankruptcy law. Assume further that on the day after the verdict the settlor filed a petition under Chapter 7 in the Southern District of New York. During the pendency of this bankruptcy the settlor receives $5,000 per month from the Trustee for investment advice.

The remainder of this section of this article analyzes the techniques available to reach the assets of an offshore trust settled with a patently fraudulent conveyance of liquid assets. The article first assumes the judgment creditor is proceeding against the settlor in a United States Bankruptcy Court. The article next assumes that the judgment creditor is proceeding in the jurisdiction where the trust is settled, in this case assumed to be the Cook Islands.

(a) Discovering the trust - Federal Bankruptcy Court: At the outset of the settlor's bankruptcy case, he is required to file a Form 1 Voluntary Petition which, on Exhibit A, has a single line where he would disclose his "Total Assets."[149] The value of his "mere contingent

[149] *See,* Collier, *supra*, Form 1-112.

remainderman's" interest would be very small indeed.[150] The settlor is also required to file a Summary within 15 days of filing the voluntary petition, which in category 18 of the Personal Property Schedule requests information on "future interests."[151] At the same time the settlor must file a Statement of Financial Affairs which, in question 9, requires the disclosure of all transfers made within one year of the date of the petition.[152] The settlor should disclose his remainder interest on the Personal Property Schedule although the value might be very small and on the Statement of Financial Affairs. The attorneys for the judgment creditor may realize something is up and could obtain a Rule 2004 examination which is like a debtor's examination under state law in that the scope of this examination is very broad, encompassing anything that relates to the "liabilities and financial condition of the debtor." The examination is done under oath.

Once the Bankruptcy court is aware of the transfer to the foreign trust for the express purpose of putting assets out of the reach of the judgment creditor, the transfer will be classified as a fraudulent transfer under Bankruptcy Code 548 as well as the fraudulent conveyancing laws of New York[153] or any other state in which the matter was heard.[154] Once the transfer is

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[150] *Query*, might some bankrupts reason *lex non curat deminimus* and simply not disclose the trust? There is a substantial body of literature in the tax area which supports the proposition that certain types of remainder interests are incapable of being valued. Before the bankrupt or his advisors take this position they should be aware of the substantial civil and criminal liability this could generate. *See,* sections III.A.3(e)-(g) *infra*.

[151] *See,* Collier, *supra*, Form 2-103.

[152] *See,* Collier, *supra*, Form 2-105.

[153] A relatively new (1962) section to the New York version of the Uniform Fraudulent Conveyances Act squarely catches the settlor in our hypothetical. This section provides:

classified as fraudulent it is possible that the court will order the settlor to instruct the trustee in the Cook Islands to return to the United States the assets which were fraudulently transferred abroad. The Cook Islands trustee would not respond to this "suggestion" issued under "duress" and the assets would stay abroad, in a blind trust, information about which would be available only to the trustee in the Cook Islands.

At this stage the bankruptcy judge has determined that a fraudulent transfer has been made to an offshore trust. An order has been issued to the settlor and possibly his attorney, both of whom were Member of the Committee of Trust Advisors,[155] to demand that the trustee return all assets to the United States.[156] The assets have not been returned. What are the ramifications of this finding by the bankruptcy court that the trust was funded with a fraudulent conveyance? The next section of this article analyzes the issues presented by this finding. They are:

*Is the debt dischargeable?

*Is the settlor (and perhaps also his attorney) subject to imprisonment for contempt for failing to obey the court's order?

"Every conveyance made without fair consideration when the person making it is in an action for money damages or a judgement has been docketed against him, is fraudulent as to the plaintiff in that action without regard to the actual intent of the defendant if, after final judgement for the plaintiff, the defendant fails to satisfy the judgement." N. Y. Debt. & Cred. Law Section 273-a McKinney 1993).

[154] *See,* Debtor Creditor Law chapter 22.

[155] Remember the United States citizens or residents who are Members of the Committee of Trust Advisors were probably removed from the Committee of Trust Advisors upon the happening of any event of duress. *See,* section I.D.8. *supra*.

[156] The assets are possibly currently located in the United States, only in an untraceable account or invested in United States securities perhaps with a foreign institutional custodian.

*Is the settlor (and perhaps also his attorney) subject to contempt for designing the trust in such a way that the trustee is compelled to ignore instructions from the settlor if such instructions are given pursuant to court order?

*Does the judgment creditor have any civil remedy against the settlor's attorney as the creator of this asset protection trust - the specific purpose of which was to shield the judgment debtor's assets from attachment after a potential malpractice verdict in favor of the judgment creditor?

*Has the settlor (and perhaps also his attorney) violated any criminal provisions in constructing a trust designed to both frustrate court orders and defraud creditors?

*Is the settlor's attorney, as the creator of this trust and engineer of the scheme, subject to discipline under the rules regulating professional conduct issued pursuant to the authority of his State Bar Act?

*Are there any extraordinary remedies which may be available to the judgment creditor to expedite seizure of the assets notwithstanding the existence of the asset protection trust?

(b) Dischargeability of debt: The bankruptcy court will not permit the discharge of the judgment in favor of the judgment creditor.[157] This is of little current utility to the judgment creditor because he cannot reach the money.

Use of contempt power

See, section I.D. *supra*.

[157] *See,* Bankruptcy Code section 523.

(c) Contempt for failing to retrieve fraudulently transferred assets: Can the bankruptcy court hold the settlor in contempt for failing to succeed in arranging for a return of the fraudulently conveyed assets? The leading case in the United States is *Maggio v. Zeitz, Trustee in Bankruptcy*.[158] In that case a turnover order was issued to Joseph Maggio to return merchandise which he no longer had. Mr. Maggio was held in contempt by the referee, the District Court affirmed and ordered Mr. Maggio jailed. The Circuit Court also confirmed, even though it found that "Maggio cannot comply with the order." The Supreme Court, Speaking through Justice Jackson, held that "if the Court is satisfied...that the bankrupt has not the present ability to comply, the commitment order should not issue."[159] The Justice also noted that "the fact that he has been under the shadow of prison gates may be enough...to convince the court that his is not a willful disobedience which will yield to coercion."[160] This case, which is still good law, stands for the proposition that the settlor (and his attorney) should not be jailed for failing to effect a return of the assets, an act which is beyond either's power to perform.

(d) Contempt for establishing a trust which frustrates the Court's orders: A separate issue is whether or not the settlor (and perhaps his attorney) are nevertheless responsible if the settlor has (with his attorney's guidance) "voluntarily and contumaciously disabled himself" from complying with a court order.[161] There are many cases on point and each is heavily fact

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[158] 333 U.S. 56, 68 S.Ct. 401, 92 L.Ed. 476 (1948).

[159] *Id* at 74.

[160] *Id.* at 76.

[161] *See, Galland v. Galland*, 44 Cal. 475, 478 (1872).

based.[162] In the instant case it is hard for either the settlor or his attorney to argue that they are not responsible for the refusal of the trustee to return assets when it is clear that the trustee is acting pursuant to instructions prepared by the settlor's attorney on behalf of the settlor, several weeks after the ill-fated surgery and the filing of a malpractice action, with the specific intent (probably inferred from the "badges of fraud")[163] of keeping assets from the reach of the grievously injured judgment creditor. Under these facts both the settlor and his attorney have a serious chance of being imprisoned for contempt simply because each, particularly the attorney, created the scenario with full knowledge of its consequences.

California provides that the maximum time of imprisonment for this "criminal" type of contempt is 5 days.[164] However, the California code provides further that "when the contempt consists of the omission to perform an act which is yet in the power of the person to perform, he or she may be imprisoned until he or she has performed it."[165] If this were California I think that the duration of the punishment for contempt for both the settlor and his attorney would be five days in jail since it is truly impossible for either to effect a return of the assets.[166] Most states do

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[162] *See,* Debtor Creditor Law chapter 22.

[163] *See,* Debtor Creditor Law chapter 22.

[164] Cal. C.C.P. Section 1218 (Wests 1993).

[165] Cal. C.C.P. section 1219. Imprisoning the settlor of an asset protection trust under this section would likely be "anticipatory contempt" which is subject to substantial constitutional limitations. *See, Contempt: State Court's Power to Order Indefinite Coercive Fine or Imprisonment to Exact Promise of Future Compliance with Court's Order -Anticipatory Contempt*, 81 A.L.R. 4th 1008 (1992).

[166] This is not the only type of punishment they may be subjected to. *See,* sections III.A.3(e)-(g) *infra*.

not have a statutory limitation on the duration of certain contempt orders. There are, however, many constitutional limits on imprisoning a debtor for non-payment of a debt or failing to obey an order which is beyond his capacity to obey.[167]

(e) Civil claim against settlor's advisors: The settlor's advisors are potentially liable to the judgment creditor for engineering on behalf of the settlor a fraudulent transfer which deprived the judgment creditor of a fund from which to satisfy his judgment. See for example *McElhanon v. Hing*[168] in which a creditor obtained a judgment against an attorney for $286,000 for assisting in a stock transfer which was a fraudulent transfer *vis a vis* an individual who was a judgment creditor of his client. Finally, unless the judgment creditor is careful in how he frames his civil complaint against the settlor's attorney, an eventual judgment in the judgment creditor's favor may not be covered by the attorney's errors and omissions insurance based on the exclusion found in many policies for intentional *quasi* criminal acts such as "civil" fraud.

(f) Criminal sanctions against the settlor and his attorney:

(i) Violations of Bankruptcy Code and other miscellaneous provisions:

Section 152 of the Bankruptcy Code provides that a fraudulent transfer of property in contemplation of a bankruptcy or with intention to defeat the provisions of the Bankruptcy Code is a crime punishable by a fine of not more than $5,000 nor more than five years of

[167] *See,* section III.A.3(f) *infra*.

[168] 151 Az. 386, 728 P.2d 256 (1985), *aff'd in part and vacated in part*, 151 Az 403, 728 P.2d 273 (1986) *cert. den.*, 481 U.S. 1030, 107 S.Ct. 1956, 95 L.Ed 2d 529 (1987). *See also FDIC v. Porco*, 75 N.Y.2d 840, 552 N.Y.S. 2d 910 (1990).

imprisonment.[169] A new section of the United States Code was added in 1990 which imposes similar fines and imprisonment for knowingly concealing assets from the Federal Deposit Insurance Corporation, the Resolution Trust Company or the National Credit Union Administration Board.[170] Further under I.R.C. section 7206(4), a transfer to prevent the collection of a tax is punishable by a fine of $100,000 and three years in prison.[171] Several states have enacted criminal fines for fraudulent conveyances.[172] It might also be possible to bring a civil Racketeer Influenced and Corrupt Organizations Act (RICO) action.[173]

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[169] This section provides in pertinent part:

> "Whoever, either individually or as an agent of officer of any person or corporation, in contemplation of a bankruptcy proceeding by or against him or any other person or corporation, or with intent to defeat the bankruptcy law, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation...[s]hall be fined not more than $5,000 or imprisoned not more than five years, or both."

This section covers both the settlor and his attorney in the case of any fraudulent transfer done specifically in contemplation of a bankruptcy filing. No cases concerning asset protection trusts have been brought under this provision of the Bankruptcy Code.

[170] *See,* 18 U.S.C. section 1032 This section is entitled "Concealment of Assets from Conservator, or Liquidating Agent of Financial Institution" imposes criminal penalties on anyone who "corruptly places or endeavors to place an asset or property beyond the reach of such Corporation, Board or conservator." 18 U.S.C. section 1032(3).

[171] Most asset protection trusts specifically instruct the trustee to pay all taxes relating to or in any way connected with the transfer.

[172] *See,* for example Cal. Penal Code sections 155 and 154. Although these code sections on their face would only apply to the settlor, the co-conspirator provisions could also be utilized to involve the settlor's attorney and other advisors.

[173] *See,* 18 U.S.C. section 1961. The RICO Act is very broad. Note that this act specifically covers any indictable act under Title 18 of the United States Code relating to mail fraud (Section 1341), obstruction of justice (Section 1503), obstruction of state or local law enforcement (Section 1511), interference with commerce (Section 1951) and any case

(ii) Violations of money laundering and related statutes

The final set of statutes which might impose criminal liability on the settlor and his attorney are the principal money laundering acts. The first of these is The Bank Secrecy Act of 1970.[174] This act requires "persons"[175] acting on behalf of any "financial institution"[176] (very broadly defined) to report large cash transactions to the government. This is accomplished by filing Form 4789[177] known by the shorthand Cash Transaction Report (or CTR) for any transaction involving more than $10,000. The Bank Secrecy act imposes penalties which apply to a "partner, director, officer, or employee of a domestic financial institution" which violates the Act. The civil fine is a minimum of $25,000 or the amount of money involved, not to exceed $100,000.[178] The criminal penalties can be a fine of up to $500,000 and ten years imprisonment.[179] Compliance with this provision is excellent. The problem is that it applies

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involving fraud under Title 11.

[174] 31 U.S.C. sections 5311-5324.

[175] "Person" is specifically defined to mean "a trustee [probably encompassing all Member of the Committee of Trust Advisors (aka Protectors)]... [and] a representative of an estate [*i.e.,* an attorney]...". 31 U.S.C. section 5312(4).

[176] *See,* 31 U.S.C. section 5312(2).

[177] *See,* I.R.C. section 6060I which requires anyone engaged in a "trade or business" to report any receipt of cash of $10,000 received in one or more related transactions. Violation of this is punishable by up to five years imprisonment and a $25,000 fine. *See also,* I.R.C. section 7203.

[178] *See,* 31 U.S.C. section 5321(a)(1).

[179] *See,* 31 U.S.C. section 5322(b).

primarily to financial institutions and does not reach the individuals requesting the financial institution's help in moving money.

To expand the reach of the Bank Secrecy Act of 1970, Congress passed the Money Laundering Control Act of 1986.[180] This act is extraordinarily broad and covers virtually any person engaging in an act to disguise the ownership of funds (allegedly derived from unlawful activity) or to avoid the Cash Transaction Report filing requirement. Violation of this Act is punishable by a fine of up to the greater of $500,000 or twice the amount of money involved or imprisonment for up to 20 years, or both.[181] In addition, the funds involved in the transaction are subject to civil forfeiture for violation of the Act.[182]

The Internal Revenue Service has recently established the Financial Crimes Enforcement Network ("FinCEN").[183] This new office of the Treasury department is to provide "government-wide, multi source intelligence and analytical network in support of the detection, investigation, and prosecution...of financial crimes."[184] All information so developed will be "appropriately" disseminated by "FinCEN" "in accordance with applicable legal requirements."[185]

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[180] This Act is scattered throughout the code at 18 U.S.C. sections 981, 982, 1956, 1957 and 31 U.S.C. sections 5321 and 5324.

[181] *See,* 18 U.S.C. section 1956(a)(2).

[182] 18 U.S.C. section 981.

[183] Announced by Treasury Secretary Nicholas Brady on April 9, 1990. Treasury Order 105-08.

[184] Treasury Order 105-08.

[185] Treasury Order 105-08.

FinCEN has a total staff compliment of 200 and a budget of approximately $ 16 Million. FinCEN has representatives from the Federal Bureau of Alcohol, Tobacco and Firearms, the Secret Service, the Postal Inspectors, the Federal Bureau of Investigation as well as "liaisons" with the Defense Intelligence Agency and Central Intelligence Agency.[186] As computer analysis capacities expand and get more sophisticated (and as the IRS expertise - augmented by former CIA and FBI agents - grows) it can be expected that the government will, in appropriate instances, be able to get detailed information on any foreign trust. An asset protection trust is not an effective tool to keep assets secret from the United States government in an aggressively pursued investigation.

(g) State Bar disciplinary action: The California Supreme Court has specifically held that "[p]articipating in a scheme to defraud creditors is a crime...and properly subjects an attorney to disciplinary action."[187] The Lawyer's Code of Professional Responsibility promulgated by the New York State Bar Association similarly provides "A lawyer shall not:...counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent."[188] I have spoken with an attorney in California who specializes in representing attorneys in

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[186] *See, Abuse of International Exchange Program a Concern to Federal Enforcement Official*, Daily Report for Executives, (BNA March 19, 1992). *See also, Hearing of the Treasury, Postal Service and General Government Subcommittee of the Senate Appropriations Committee*, Federal News Service, (Federal Information Systems Corporation March 20, 1990), (Testimony by Treasury Secretary Nicholas Brady) and *Money Laundering Alert*, Alert International, April 1990, Vol. 1, No. 7, Page 3.

[187] *Allen v. State Bar*, 20 Cal.3d 172, 178, 570 P.2d 1226, 1229, 141 Cal. Rptr. 808, 811 (1977).

[188] *See,* D.R. 7-102A.7. *See also* American Bar Association Model Rules of Professional Conduct rule 1.2(d).

disbarment proceedings. It is clear, at least in California, that the Bar would try for disbarment. The specialist thinks that the minimum penalty would be a three year suspension with restitution as a condition to restatement. I have no reason to believe that the Bar Association of any other State would be significantly less severe.

(h) Extraordinary remedies:

(i) *Mareva* injunction[189]

If the judgment creditor is able to pierce the veil of secrecy surrounding the settlor's asset protection trust[190] the judgment creditor may be able to get a *Mareva*[191] injunction. In that case an English court froze money of a foreign debtor in an English Bank upon the showing that there was a great danger that the assets would be disposed of so as to frustrate the payment of a valid obligation. The petitioner had to satisfy the court that an obligation did indeed exist. The standard is simply what is "just and right." This is a rapidly expanding area of the law. In the instant case, provided the judgment debtor has a formal judgment from a United States Court labeling the transfer as "fraudulent," the judgment creditor should not have any problem

[189] An *ex parte Mareva* injunction has been the vehicle utilized by aggrieved creditors to attempt to reach assets held in a Cook Islands trust. *See,* section III.B.4. *infra*.

[190] Whomever divulges the information faces a large fine (up to U.S. $10,000) and up to one year in imprisonment under Section 23 of the Cook Act and related provisions of the Trustee Companies Act. Further, if one of the trustees divulged information he is likely a solicitor and might be breaching the attorney client privilege and his duties as a trustee under the terms of the trust and Cook Islands law. He could be immediately disbarred.

[191] *Mareva Compania Naviera S.A. v. International Bulkcarriers S.A.*, U.K. Court of Appeal, 2 Lloyd's L.Rep. 509.

establishing to a court's satisfaction that the assets are at risk of being removed from the jurisdiction. However, in Hypothetical 1, where there is no fraudulent conveyance, the judgment creditor has a very hard burden in that the transfer to the foreign trust has been respected by the United States court. Provided the assets are trust assets and not the personal assets of the settlor the judgment creditor will not succeed in obtaining a *Mareva* injunction where the transfer is clearly not fraudulent. The traditional rule is that no jurisdiction protects a creditor before he gets a judgment and the judgment creditor will not have a judgment against the trust.[192] Finally, procuring the *Mareva* injunction is no guarantee that the judgment creditor will be able to reach the assets or prevent the automatic implementation of duress provisions.[193]

(ii) *Attachment* under Swiss Law

Switzerland now allows for the *Attachment*[194] of property. This remedy is available to both Swiss and foreign creditors. It is enforceable against debtors who are non-residents of Switzerland. Most importantly, this remedy is available against any property in Switzerland for claims unassociated with Switzerland and not based on Swiss law. In other words, this is a remedy which is available to non-Swiss against non-Swiss on claims completely unassociated with Switzerland.

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[192] The judgement creditor may have a charging order against the trust. *Quere*, will a court in a civil law jurisdiction attempt to exercise equitable type powers to justify disregarding the trust or to force the trustee to deliver trust assets. No cases have dealt with this issue. See Lowenfeld, *supra* and Hetherington, Mareva Injunctions (The Law Book Company (Australia) 1983).

[193] *See,* section III.B.4. *infra*.

[194] The procedure is authorized by Section 271 of the Swiss Federal Statute of Debt Collection and Bankruptcy (*Bundesgeseth uber Schuldbetreibung und Konkurs*).

Attachment is available upon a showing that an unsecured debt is due and unpaid, that the debtor is not domiciled in Switzerland, that the debt is in connection with pending litigation outside Switzerland and that the property inside Switzerland would be immediately subject to *attachment* if the judgment creditor were successful in the related action. Such an *attachment* may be had by *ex parte* order (thereby keeping the Cook Island trustee in the dark until it is possibly too late to take any action). In the event that the judgment creditordoes not know which bank is holding the assets all he need do is file separate petitions until he finds the money. Any bank served with a writ of *attachment* must disclose whether it holds assets of the debtor.[195]

(iii) The turncoat custodian (usually a bank)

Care should be taken in the selection of the custodian (normally a bank). The preferred entities (at least, once an event of duress occurs) have no business contact at all with the United States or, at a minimum, have so little contact that they are unlikely to become subject to the jurisdiction of a court in the United States. There are several reported examples of banks or trust companies abrogating confidentiality laws when the banks or trust company's assets were put at risk. For example, in one well known case[196] the Miami branch of the Bank of Nova Scotia was directed to cause its related Bahamian subsidiary to deliver information on certain Bahamian accounts to the United States in violation ofthe Bahamian bank disclosure laws. The Bank faced

[195] *See,* Wirth, *Attachment of Swiss Bank Accounts: A Remedy for International Debt Collection*, 36 Business Lawyer 1029 (1981). And to think, in 1981 we all thought Swiss Bank accounts were confidential!

[196] *Re Grand Jury Proceedings*, 691 F.2d 1384 (11th Cir. Fla. 1982), *cert denied Bank of Nova Scotia v. United States*, 462 U.S. 1119, 103 S.Ct. 3086, 77 L.Ed.2d 1348 (1983).

fines of $25,000 per day and quickly complied. There is some authority that the bank may be liable to the customer for breach of its duty of confidentiality.[197]

B. Challenge in Cook Islands Court

The judgment creditor could also try to attack the trust in the Cook Islands before a local Cook Islands judge.[198] For the purposes of this section we are still assuming that the trust was formed in blatant violation of both state and Federal fraudulent conveyancing laws and that the United States Bankruptcy Court has ordered the settlor and his attorney to effect a return of the assets held in the asset protection trust.[199] We know that no attacks against "international trusts" settled in the Cook Islands have succeeded to date. We also know that no cases are reported because of the secrecy requirement of the Cook Act.[200] Nevertheless, the judgment creditor

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[197] *See, Young v. Chemical Bank, N.A.*, N.Y.L.J. August 7, 1992 at 21 (N.Y. Co. Sup. Ct. 1992) and Angello and Potti, *Crime Prevention and Customer Confidentiality*, N. Y. Law J., January 14, 1993, page 5. *See also,* Lowenfeld, *supra*.

[198] The Cook Islands has a three tier court system. The court of original jurisdiction is known as the High Court. Its judges are drawn largely from the ranks of the New Zealand judiciary and are thus of a high calibre. Appeals from decisions of the High Court lie with the Cook Islands Court of Appeal. This again, typically comprises judges of New Zealand's High Court and Court of Appeal, appointed to the Cook Islands bench by the Cook Islands Government. Appeals from the Cook Islands Court of Appeal lie to the Privy Council in London. Personal communication from Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands. *See also,* Frame, *The Cook Islands and the Privy Council*, 14 Vict. Well. L.R. 311 (1984).

[199] The United States has been known to place great pressure on foreign states or domestic courts to change laws which, in the opinion of the State Department, impeded commerce. *See, Jackson v. Peoples Republic of China*, 794 F.2d 1490 (11th Cir. Ala. 1986) *reh'g denied, en banc,* 801 F.2d. 404 (11th Cir. Ala. 1986) and *cert. denied*, 480 U.S. 917, 94 L.Ed.2d 687, 107 S.Ct. 1371 (1987).

[200] Cook Act section 23.

decides to proceed on principle, a tactic almost always a mistake in business litigation. Here are the barriers he will have to overcome.

1. Retention and payment of a United States law firm to manage the litigation: The judgment creditor will likely have to retain a firm experienced in international litigation to attack the trust in the Cook Islands. It is highly unlikely that the matter will be taken on a contingent or reduced fee basis, thus the judgment creditor will likely have to pay whichever firm he hires to manage this proceeding its normal hourly rates. This firm will undoubtedly require a substantial retainer. It is also probable that this firm will advise the judgment creditor in writing that his case is very difficult and that it is against their better judgment and his best interests to pursue it. It could be malpractice or even unethical to take money for this case without such an exculpatory letter. The judgment creditor's new lawyers will also require that the judgment creditor hire another lawyer to represent him in connection with his execution of this exculpatory letter.

2. Accessibility: Once retained, the United States lawyers supervising the litigation have the problem of getting a copy of the Cook Islands law. Until the publication of this article, neither NYU, Columbia, Yale, Harvard, Boalt, USC, UCLA, lexus, or westlaw have a copy of the Cook Islands Trust Act.[201] To simply find the law could require a substantial amount of work.

3. Retention and payment of a Cook Islands law firm (plus "Security for Costs"): Martindale-Hubbell does not list even one lawyer in the Cook Islands. No lawyer in New Zealand states a specialization in Cook Islands Law. It is difficult to find a lawyer. However,

[201] This problem of inaccessible law is true with many of the jurisdictions listed in section II.B. *infra*.

after many expensive calls and substantial time, the judgment creditor's United States lawyers will locate a Cook Island lawyer. Almost undoubtedly he works for one of the five licensed trust companies. This Cook Islands lawyer would inform the United States lawyers supervising the domestic aspects of the collection effort that it is unethical in the Cook Islands to take a matter on a contingency. Thus, he will ask for a substantial retainer up front. In addition, under the English system adopted in the Cook Islands, the losing party will most probably have to pay for the legal fees of the winner. In this case, the judgment creditor would, as a condition to proceeding with his case, very possibly have to post security (normally cash) for the full amount of the defendant's projected fees and costs.[202] This fund will be available to pay the defendant's cost of defense in the event that the defendant prevails.

4. Procedural barriers:[203] In every case which has come before the Cook Islands courts, the judgment creditor has obtained a copy of the international trust[204] often *via* discovery in the

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[202] Rule 37 of the Cook Islands Code of Civil Procedure provides:

> "(1) If the plaintiff in any proceedings is resident out of the Cook Islands, the Court, on the application of the defendant, may order security to be given for the costs of the proceeding to the satisfaction of the Registrar, and may order the proceedings to be stayed until such security has been given. The defendant shall apply promptly after the fact of such residence out of the Cook Islands has come to his knowledge.
>
> (2) A person ordinarily resident out of the Cook Islands may be ordered to give security though he may be temporarily resident in the Cook Islands."

[203] The following history of attacks on asset protection trusts on the Cook Islands was provided by Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands.

[204] The actual trust document is not filed with the Cook Islands Registrar of International Trusts.

United States. Armed with a copy of the international trust, the attorneys for the aggrieved creditors have brought suit in the Cook Islands alleging fraud and contemporaneously seeking a *Mareva* injunction to freeze the assets of the trust and preclude the Cook Islands trustee from activating the Cuba clause flight provisions.[205] In each case the application for the *Mareva* injunction has been made *ex parte* without notice to the Cook Islands trustee.

Several *ex parte Mareva* injunctions have been granted but no creditors have managed to reach the trust assets. "The judges of the High Court are now familiar with the provisions of section 13K(3) and (4) [of the Cook Act][206] such that judgment creditors are finding it increasingly difficult to gain a tactical advantage in the Cook Islands High Court."[207] Furthermore, since a *Mareva* injunction is normally not granted without security for costs, judgment creditors are routinely required to pay substantial security. "In view of the procedural hurdles faced by judgment creditors in a jurisdiction which promotes itself as specializing in asset protection trust work, plaintiffs in the few cases filed in the Cook Islands High Court have in each case chosen to settle their claims or leave them inactive, in frustration, choosing instead

[205] *See,* section III.A.3(h)(i) *supra*.

[206] These sections deal with the conditions precedent to implementing an action and basically require the filing of affidavits in the *in camera* proceeding establishing that the statute of limitations has not run and, if fraud is alleged, evidence that it can be established under the standards of the Cook Act.

[207] Timothy P. Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands, personal communication (June 22, 1993).

to return to the United States in an attempt to pursue trustees, protectors or beneficiaries there.[208] Any proceedings will be heard *in camera* and no formal or published records will be kept.[209]

5. Substantive barriers: If the judgment creditor survives the procedural attack, his lawyers still have the overwhelming burden of the clear language of the statute specifically validating trusts exactly like the one set up by the settlor. It is important, in this context, to realize that the Cook Act has been enacted to encourage the registration of international trusts and thus any possible ambiguity in the legislation will be considered by the court giving the statute such "fair large and liberal constructions and interpretations as will best ensure the attainment of the object of the Act and of such provision or enactment according to its true meaning and spirit."[210]

6. The disappearing trust: Assume the judgment creditor posted his security for costs, assume he survived the procedural attack, assume a Cook Islands court decided to hold in his favor (thereby ruining a major industry of the jurisdiction within which the court is established), then the judgment creditor will still have the same problem all over in another jurisdiction. In particular, the trustee will have resigned and another trustee will have taken its place in an entirely different jurisdiction. This can happen automatically in certain circumstances. Most frustrating of all, the Cook Islands trustee cannot be compelled, and indeed must not, under pain

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[208] Personal communication from Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands (June 22, 1993).

[209] *See,* section II.B. *supra*.

[210] Acts Interpretation Act 1924.

of criminal penalties, disclose the jurisdiction to which the trust situs was changed.[211] It is probable that neither the settlor nor his lawyer will have information at this time concerning the new situs of the trust or the situs of the assets. Of course, upon request, the settlor would be given a blind accounting and would probably be told details of the new situs as long as the trust document permitted the disclosure of this information under the current circumstances.

SECTION IV

IV. UNITED STATES TAXATION OF ASSET PROTECTION TRUSTS

A. Desired tax treatment - basic assumptions

An asset protection trust is a flexible tool that is crafted specifically for a client. The following discussion identifies tax attributes which most properly drafted asset protection trusts should have. In order to keep the discussion manageable, the following discussion assumes that the asset protection trust is settled by a single United States citizen and resident; that the transfer to the trust is not a fraudulent conveyance; that the settlor is solvent, has no significant debts, is employed and that only a moderate portion of his liquid assets are transferred into the asset

[211] If at this time the judgement creditor's lawyers start thinking that the trustee on the Cook Islands and the settlor are somehow plotting or conspiring against the judgement creditor to defraud him they should examine Section 13D of the Cook Act insulating the trustee from the impact of a foreign judgement, and the entire Cook Act, particularly Article 13, specifically authorizing, and in fact requiring, that the trustee do what he has done.

A thornier issue arises if a trustee or officer of a Cook Islands trust Company is "tagged" with service of process while visiting the United States. Most nations of the world will not enforce a judgement based on "tag" service, particularly if the defendant does not appear and defend on the merits. *See,* Lowenfeld, *supra*.

protection trust; that the settlor is appointed as Chairman of the three member Committee of Trust Advisors; that his attorney, a United States citizen and resident, is also a member along with an attorney in an affiliated foreign office; that the trust is settled in the Cook Islands; that all appropriate formalities, including registration and payment of trustee fees, are carefully observed; and, that the settlor does not intend to expatriate.

The settlor's tax advisor should be prepared to opine that the expected income, estate, gift and excise tax treatment of the asset protection trust and the transfer to the trust are as follows:

1. Income Tax:

-The legal entity is a "trust" and not an "association"-

-The trust will be characterized as a "grantor" trust-

-No gain or loss is recognized in connection with the transfer to the trust-

-All expenses incurred in connection with the operation of the trust (subject to the 2 percent adjusted gross income limitation) are currently deductible.

-The trust may own interests in United States or foreign corporations or partnerships and will receive substantially the same tax treatment as a United States trust doing the same-

-The trust, or entities owned by the trust, may, under some circumstances, make payments to the Settlor.

2. Gift tax consequences:

- The initial transfer to the trust is not subject to gift tax-

3. Estate tax consequences:

-The estate tax, computed in the same way as it would it the trust were a domestic trust, is due upon the settlor's death-

4. Excise tax consequences:

-The transfer to the trust does not trigger an excise tax-

The remainder of this section examines the underpinnings of this opinion letter.

B. Income Tax Consequences of an asset protection trust

1. Classification as a trust

(a) Basic structure

A "trust" is not defined in the Internal Revenue Code. However the regulations and cases do provide guidance. The best definition is in Treasury Regulations section 301.7701-4 in which it is stated:

> In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules of chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand

> in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.
>
> An arrangement will normally be treated as a trust for tax purposes if:
>
> 1. It is created by a purposeful declaration pursuant to the laws of a jurisdiction which recognizes trusts,
>
> 2. the trustee takes title to the property transferred to the trust for the purpose of protecting or conserving it for the beneficiaries,[212] and
>
> 3. the beneficiaries cannot share in the discharge of the trustee's responsibility.

These three requirements are satisfied. First, the settlor's asset protection trust is established pursuant to the laws of a jurisdiction which recognizes trusts. A purposeful and formal declaration of trust has been made by the settlor, accepted by the trustee and registered in the Cook Islands. The Cook Islands is a common law jurisdiction which applies the principles of equity derived from the common law courts of England. Second, the trust indenture specifically provides that the trustee is charged with the responsibility of preserving and protecting the trust

[212] If the trustees accumulate income and distribute it to the settlor upon termination of the trust they are in realty protecting and conserving the corpus for the settlor.

corpus for the beneficiaries. Finally, the beneficiaries are specifically prohibited from sharing in the discharge of the trustee's responsibility.

The Cook Islands derive their trust law directly from the English laws that were adopted by New Zealand. In addition to this long history of recognizing trusts it has enacted an act specifically dealing with trusts which has as one of its principal tenants to make sure that any trust formed and registered pursuant to the Cook Act is recognized as a valid legal entity.[213]

Nevertheless, it is interesting to consider whether the Internal Revenue Service might advance the argument that trusts formed in the Cook Islands are not "trusts" for United States tax purposes on the theory that the "ordinary rules of chancery or probate courts," as required by the above quoted regulations, are not observed or recognized in the Cook Islands. To support this view the Service could refer directly to several sections of the Cook Act which do not "do equity" in the traditional British sense.[214] In particular, the IRS might point to the specific override of the Statute of Elizabeth type fraudulent conveyancing act which protects future

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[213] *See,* section II.C. *supra*. Several civil law jurisdictions such as Liechtenstein and Jersey permit the establishment of entities which are similar to common law "trusts." In Liechtenstein these entities are the *Anstalt* (establishment), the *Stiftung* (foundation), the *Treuhanderschaft* (private trust) and the *Treuunternehmen* (commercial trust). Care should be taken in utilizing non-common law jurisdictions because fundamental yet subtle differences exist (*e.g.,* the *Anstalt* is treated under English law but lacks separate legal entity status) which can have a wide reaching impact on an asset protection plan. The Internal Revenue Service has not spoken on the issue of whether or not it would recognize such statutory trusts for the purposes of applying Treas. Reg. Section 301.7701-4. The Internal Revenue Service could always argue that such a trust is not regulated by rules applied in chancery or probate courts (common law courts) and that such an entity is something other than a trust such as an association.

[214] *See,* sections II.C. and III.B. *supra*.

unknown creditors from being intentionally defrauded.[215] In addition the IRS might point to the procedural provisions such as: 1) the one year statute of limitations on transfers to the trust, 2) the secrecy requirement for the *in camera* hearing, 3) the fact that any challenge only helps that specific creditor and does not invalidate the transfer to the trust, 4) the requirement that United States judgments against Cook Trusts, even if the trust were properly served and actually defended on the merits, would not be recognized, thereby forcing the action to be relitigated in the Cook Islands,[216] 5) the exculpatory provisions and 6) the provision fostering the "disappearing trust." These are certainly not provisions which the chancellor doing equity would follow.

At the present time the Internal Revenue Service has not adopted this view. If serious doubt exists the taxpayer can always get a ruling on the characterization of the trust as a trust versus an association taxable as a corporation.[217] In the instant hypothetical the offshore trust will indeed be treated as a trust for tax purposes. Once this hurdle is passed, the next issue to

[215] Many civil law jurisdictions which have enacted a civil law of trusts or have entities which are very similar to trusts (i.e. Liechtenstein or Jersey) still do not apply the principles of chancery courts.

[216] In the past, this was considered a serious breach of international law and was a basis in some cases to refuse to enforce judgements from jurisdictions which refused to recognize ours. Some states still have strong reciprocity requirements. *See,* Lowenfeld, *supra*.

[217] Even though the Internal Revenue Service will issue such a ruling, *see,* Treas. Reg. Section 301.7701-2(a)(2) it will not rule on whether or not a trust is domestic or foreign. *See,* Rev. Proc. 93-7, 1993-1 I.R.B. 170. A ruling is not a valid option if speed or confidentiality are important.

evaluate is whether it will nevertheless be taxable as an association under the *Morrissey* regulations.[218]

(b) Trust v. Association

Care must be taken to make sure that the trust is not characterized as an association taxable as a corporation rather than a grantor trust.[219] The *Morrissey* case identified six principal characteristics of a corporation. These are:

1. Associates
2. An objective to carry on a trade or business and divide the profits therefrom
3. Continuity of life
4. Centralized management
5. Limited liability
6. Free transferability of interests.

The Supreme court identified the first two criteria as "essential."

The regulations attempting to apply the *Morrissey* case apply a mechanical test where an unincorporated association is classified as a corporation only if it possesses more of these six corporate characteristics than it lacks. In applying this test, all characteristics common to both

[218] *See,* Treas. Reg. sections 301.7701-2 and 301.7701-4. These regulations are named after the famous case *Morrissey v. Commissioner*, 296 U.S. 344, 80 L.Ed. 263, 56 S.Ct. 289 (1935).

[219] This area has been carefully and completely analyzed by several commentators. *See,* particularly Bittker and Lokken, *supra*. paragraph 90.1.

organizations are ignored. The regulations also require an objective to carry on a business for profit as a minimum condition for corporate status.

Trusts and corporations share four corporate characteristics. These are centralized management, continuity of life, free transferability of interests and limited liability. Thus, to determine if the asset protection trust will be treated as a trust or association for Federal income tax purposes, the only two criteria examined are: 1) the existence of associates and 2) an objective to carry on a trade or business and divide the profits therefrom. To be classified as an association taxable as a corporation rather than a trust the entity must have both of these characteristics.[220]

Associates

The asset protection trust is a will substitute. In many cases the beneficiaries will not even know that they are beneficiaries. The Tax Court, in *Bedell Trust v. Commissioner,*[221] a recent decision in which the commissioner has acquiesced, indicated that purposeful planning is necessary to satisfy the "associates" requirement. The Tax Court took particular notice of the fact that the beneficiaries of the testamentary trust were taking an active role in the management of the trust and that one son took primary charge of these affairs and actually received a salary; but, noted that these factors alone were not enough to cause the beneficiaries to be classified as associates. The Tax Court noted that the trust was not the result of a planned voluntary association. The beneficiaries of this testamentary trust did not expend "a common effort to

[220] *See,* Treas. Reg. section 301.7701-2(a)(2).

[221] *Bedell Trust v. Commissioner*, 86 T.C. 1207 at 1219 (1986) *acq. in result in part*, 1987-2 C.B. 1.

enter...into a combination for the conduct of a business enterprise."[222] It is unlikely that the beneficiaries would be classified as associates.

An objective to carry on a trade or business and divide the profits thereon

The second factor which must be present for the trust to be treated as an association taxable as a corporation is a business objective. Offshore trust companies are normally not willing to accept trusts which directly own and manage a business. As discussed above, trust companies are willing to hold passive investment assets such as limited partnerships, stocks and bonds and title to valuable personalty such as gems and precious metals. In an aggressively managed portfolio the trustee will always employ professional management. One effect of this practical constraint is that it is unlikely that the activities of a typical asset protection trust, and particularly our hypothetical trust in which the only trust asset is high grade municipal bonds, will be sufficient to be classified as meeting this requirement for "an objective to carry on a trade or business and divide the profits therefrom."

Further, this business objective requirement is normally applied to reclassify trusts formed as an investment vehicle as corporations. One commentator, in the final analysis, boils it down to the following: "The regulations [dealing with the circumstances under which a trust will be characterized as an association taxable as a corporation]...come to rest, in the last analysis on the purpose for which the trust was created: whether its primary objective is to hold, protect, and conserve the trust property for beneficiaries under the ordinary rules applied in chancery

[222] *Bedell Trust v. Commissioner*, 86 T.C. 1207 at 1219 (1986) *acq. in result in part*, 1987-2 C.B. 1.

courts (an "ordinary trust"), or to carry on a joint business enterprise for profit (a "business trust"). Trusts created by gift or will are rarely classified as associations, whereas trusts created as investment vehicles are often strictly scrutinized."[223]

2. Classification as a grantor trust

The next question which the opinion letter should address is the treatment of the trust as a "grantor" trust under United States tax law. Whether or not the trust is classified as a domestic or "foreign" trust is irrelevant to this issue. If the grantor trust provisions of the Internal Revenue Code apply, the settlor of the asset protection trust will be treated as the owner of all of the trust assets. As a result, the settlor will be taxed directly on all items of "income, expense and credits" of the trust regardless of actual distributions from the trust.[224]

The asset protection trust will be treated as a grantor trust if the settlor possesses any one of the following powers or rights:

1. A "reversionary interest in either the corpus or income therefrom" which exceeds five percent of the value of the trust as of the date of the trust's inception,[225] or

2. A "power of disposition, exercisable by the grantor or a nonadverse party,[226] or both, without the approval or consent of any adverse party,[227] or

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[223] *See,* Bittker and Lokken *supra* paragraph 90.1.3.

[224] *See,* I.R.C. section 671.

[225] *See,* I.R.C. section 673.

[226] I.R.C. section 672(a) defines "adverse party" as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in

3. Administrative powers[228] which give the settlor certain powers to deal with trust assets without typical fiduciary review or control, or

4. A "power to reinvest in the grantor title" to trust assets (i.e. power to revoke),[229] or

5. The power to arrange for the trust's income to be

(a) distributed to the grantor (or his spouse),

(b) accumulated for the grantor (or his spouse), or

(c) utilized to buy specified life insurance on the grantor or his spouse,[230] or

6. Has children or other beneficiaries, other than a wife, who he is legally obligated to support who actually receive support payments.[231]

In the instant case the asset protection trust will be specifically crafted in such a way that it will be classified as a grantor trust.[232] In particular:

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the trust."

I.R.C. Section 672(b) defines "nonadverse party" as "any person who is not an adverse party."

[227] *See,* I.R.C. section 674.

[228] *See,* I.R.C. section 675.

[229] *See,* I.R.C. section 676.

[230] *See,* I.R.C. section 677.

[231] *See,* I.R.C. section 677(b).

[232] There are a variety of non-tax reasons to prefer this structure, *see,* section I.D.2. *supra*. Further, because in our hypothetical the grantor is a United States citizen or resident and the beneficiaries are United States persons, the trust will automatically be classified as a grantor

Regarding the settlor's reversionary interest: The settlor's reversionary interest exceeds five percent of the value of the trust. In particular, "assuming the maximum exercise of discretion in favor of the grantor" as is required by I.R.C. section 673(c), the trustee may retain all assets and income earned during the term of the trust and distribute this on termination of the trust. If the trust is extended because of the triggering of a duress provision, this is treated as a new transfer to the trust.[233]

Regarding the settlor's powers: The trustee, a non-adverse party,[234] may, without the consent of an "adverse party," but possibly subject to the veto power of the Committee of Trust Advisors, be able to distribute corpus (perhaps to a spouse) or allocate income without being subject to a standard[235] or add beneficiaries other than after-born children or after-adopted children.[236]

Income accumulation and distribution: The asset protection trust is often written so that the trust income is distributed to a spouse or accumulated for the grantor and or his spouse without the consent of an adverse party but normally subject to the veto power of the Committee of Trust Advisors.[237]

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trust. *See,* I.R.C. section 679 and section IV.B.6. *infra*.

[233] *See,* I.R.C. section 673(d).

[234] *See,* I.R.C. section 672(a).

[235] *See,* I.R.C. sections 674(b)(3) and 674(b)(5).

[236] *See,* I.R.C. subsections 674(c) and 674(d).

[237] *See,* I.R.C. subsections 677(a)(2) and 677(a)(2).

In the instant case, there is no doubt that the trust, provided it is indeed treated as a trust, will be subject to the grantor trust provisions of I.R.C. sections 671-679.

3. Consequences of transfer to asset protection trust

The transfer to a trust is not a "sale or other disposition" under I.R.C. section 1001. It is not a taxable event. No gain or loss is either realized or recognized by the settlor or the trust on this transfer.[238]

4. Treatment of legal, trustee and other formation and operating expenses

All reasonable fees paid by the settlor to establish and administer the asset protection trust are deductible under I.R.C. section 212 as "ordinary and necessary expenses paid or incurred...(1) for the production or collection of income; [or] (2) for the management, conservation, or maintenance of property held for the production of income...." Treasury Regulations section 1.212-1(g) specifically provides for the deductibility of "[f]ees for services of investment counsel, custodial fees and similar expenses...." Subsection (i) of these regulations specifically provides for the deductibility of "[r]easonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciary fees...." Thus, all reasonable administrative fees to the extent that they exceed two percent of adjusted gross income should be deductible.[239] Normally negotiated fees between unrelated parties such as the settlor and the Trustee will be deemed reasonable.

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[238] *See,* Bittker & Lokken *supra*, chapter 81.

[239] *See,* I.R.C. section 67 which permits deductibility of such expenses only to the extent that they exceed two percent of adjusted gross income.

5. Consequences of offshore asset protection trust being classified as "United States" or "Foreign" trust

The settlor's asset protection trust is registered in the Cook Islands, a foreign country, as an "international trust." Applying common sense it should be classified as foreign. This is not true. The trust may, in some circumstances, be treated as a United States resident for tax purposes.

Neither the Internal Revenue Code nor the Regulations define the term "domestic trust." I.R.C. section 7701(a)(31) defines "foreign trust" as a "trust,...the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A."[240] Thus, a foreign trust for tax purposes is a trust which is taxed as a non-resident alien. The "nationality" of the trust is the Cook Islands. It is an alien; however, its structure and conduct may be such that this "alien" is treated as a "resident" for United States income tax purposes. An exclusion is provided with respect to individuals by I.R.C. section 872(a) and with respect to corporations by I.R.C. section 882(a).[241] No such statutory exclusion exists with respect to trusts, therefore: (1) they are considered foreign whenever they can be realistically classified as non-resident aliens[242]

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[240] *See,* Rev. Proc. 90-6, 1990-1 C.B. 430.

[241] I.R.C. section 7701(b), which was added by the Tax Reform Act of 1984 in an effort to lend more certainty to the classification of an alien as a "resident", applies only to individuals and not trusts.

[242] *See,* Treas. Reg. section 301.7701-5.

and, (2) since the statutory rules apply only to natural persons,[243] we must look to the regulations predating the statutory rules.[244] These regulations[245] however were drafted with human beings in mind and refer exclusively to physical presence. This is an impractical and illogical test to apply to artificial entities such as trusts; however two courts have tried[246]. In *B.W. Jones Trust v. Commissioner* the Fourth Circuit held that five trusts created under English laws, by an English settlor, in favor of beneficiaries who were English citizens and English residents, which had three of four trustees in England to be a United States resident. The court pointed out that ninety percent of the trusts' assets were securities issued by American corporations, which were held in a box at National Park Bank of New York, that the trusts maintained an office in the United

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[243] *See,* Staff Report of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 469 (Comm. Print 1984).

[244] For a good discussion on the classification of trusts as "foreign" or "domestic" *see* Bittker and Lokken *supra* paragraph 65.3.2.

[245] *See,* Treas. Reg. section 1.871-2(b) which provides:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned.

[246] *B.W. Jones Trust v. Commissioner* 132 F.2d 914 (4th Cir. 1943). *See also Maximov v. United States* 373 U.S. 49, 10 L.Ed.2d 184, 83 S.Ct. 1054 (1963) *affirming* 299 F.2d 565

States with a full time secretary and that one of the English trustees regularly traveled to the United States to meet with the American trustee where investment decisions were made and accountings prepared. The Fourth Circuit, speaking through Circuit Judge Parker, noted "[n]o individual who was present and operating within the country as were these trusts could claim to be a nonresident."[247] The *B.W. Jones Trust* case was cited with approval by Justice Goldberg in *Maximov*, speaking for a unanimous Supreme Court, which held that a trust formed in Connecticut, governed by the laws of Connecticut, with a Connecticut trustee and United States (implied) situs assets but British citizens and residents as beneficiaries, was not a "resident of the United Kingdom"[248] and therefor could not avail itself of a certain provision of the United States-United Kingdom tax treaty.

One leading commentator suggests that the rational of the *B.W. Jones* decision is not a good test for trusts and that the "analogy to individual residence should ...be as follows:

> Under the test of the regulations, an individual is a resident if his physical presence in the United States sufficiently predominates over his presence in foreign countries that it is reasonable to say that, at least for the time being, he has made his home in this country. Similarly, a trust should be classified as a resident

(2nd Cir. 1962).

[247] *B.W. Jones Trust v. Commissioner* 132 F.2d 914, at 916 (4th Cir. 1943).

[248] *Maximov v. United States* 373 U.S. 49, 10 L.Ed.2d 184, 83 S.Ct. 1054 (1963)

only if its physical connections with the United States predominate over those to foreign countries."[249]

The approach of *B.W. Jones* has been adopted by the Internal Revenue Service.[250]

One commentator has attempted to break the analysis of this issue into a six factor test to determine the situs of a trust. These factors are:

"(1) the country under whose laws the trust was created,

(2) the situs of the trust's corpus,

(3) the nationality and residence of the trustee,

(4) the situs of the trust administration,

(5) the nationality and residence of the grantor and

(6) the nationality and residence of the beneficiaries."[251]

The Senate Finance Committee in its Report on the Tax Reform Act of 1976 references all but the situs of the trust administration in its report which states:

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[249] See Bittker and Lokken, *supra*, paragraph 65.2.

[250] *See,* Rev. Rul. 81-112, 1981-1 C.B. 598, at 599 in which an estate was treated as a nonresident where the assets and administration were abroad but the decedent was a U.S. citizen, albeit an expatriate, for 20 years and the beneficiaries were U.S. Citizens. *See,* Rev. Rul. 64-307, 1964-2 C.B. 163 where the estate of a United States citizen and resident was treated as a United States estate even though eighty percent of the assets were foreign and were probated abroad by a foreign executor. *See also,* Rev. Rul. 62-154, 1962-2 C.B. 148 in which the Commissioner acknowledged that the estate of a non-resident alien may be a United States resident.

[251] Zaritsky, *supra* at A-6. *See also,* Priv. Ltr. Ruls. 87-23-010, 85-24-010, 78-32-003 and 79-17-087, not cited in the Zaritsky portfolio, which, when read together, lend support to this six factor test.

> The Internal Revenue Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. However, Internal Revenue Service rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor and the nationality of the beneficiaries. If an examination of those factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien and thus a foreign trust.[252]

The most important factors seem to be the location or the trust assets, the place of administration and the residence and nationality of the trustee. A trust will normally be treated as a United States trust as long as it has a United States trustee administering United States situs assets from a location in the United States.

In the instant case the attorney, as the draftsman of the trust, has much power to control whether or not the trust is considered domestic or foreign. The attorney, in consultation with the settlor, can arrange to have one or two United States co-trustees. The Cook Act requires at least one of the trustees be a Cook Islands resident.[253] The settlor's attorney, through instructions concerning administration of the trust, can provide that assets held by the trust are to be held and administered in the United States (except in times of "duress"). The beneficiaries are United States citizens and residents. In this case, the trust would have a preponderance of domestic

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[252] S. Rep. No. 938, 94th Cong., 2nd Sess., at 215 (1976).

[253] *See,* Cook Act Part I, section 2, definition of "international trust."

characteristics. The corpus would be in the United States, one or two of the trustees (as well as two of the three members of the Committee of Trust Advisors) would be United States citizens and residents, the trust would be largely administered in the United States, the grantor is a United States citizen and resident and the beneficiaries are all United States citizens and residents. The only foreign factors are the settlement of the trust under Cook Laws and the fact that one or two of three trustees are not United States residents. Under this scenario the trust should be classified as a United States resident. In times of duress when the trust assets are removed from the United States, administration is transferred abroad and United States trustees or Advisers are removed, the trust would be classified as foreign.

In the case of a trust settled by a United States person with United States beneficiaries the stakes are largely inconsequential.[254] In the instant case the asset protection trust is a grantor trust settled by a United States citizen and resident. The settlor is taxed on all trust income pursuant to the grantor trust rules as and when income is incurred, whether or not distributions are made to the settlor and whether or not the trust is domestic or foreign. The distinctions are twofold: If the trust is foreign it cannot be a shareholder in a Subchapter S corporation[255] and it is subjected to a more burdensome reporting regime.[256] It may be wise to recommend that a protective filing of

[254] In many cases the stakes are tremendous since to find that the trust is a domestic trust is to subject its to taxation on its gain which, in the case of a trust settled by a nonresident alien would otherwise go untaxed.

[255] *See,* I.R.C. section 1377.

[256] *See,* section IV.F. *infra*.

the required forms be made.[257] Filing these forms does not create a tax liability, but failing to file will generate penalties.[258] Further, setting up the basic structure where all necessary filings are made may be wise, particularly since the trust could become "foreign" at any time following an event of duress.[259]

(a) Contribution to corporation or partnership

Institutional trustees throughout the world will not normally agree to hold businesses directly. The trustees worry that direct ownership will have a number of undesirable consequences including the subjection of the trustee to liability in the jurisdiction of the business. Normally, all a trustee will agree to accept is valuable personal property such as diamonds or gold or passive insulated interests such as limited partnership interests and corporate stock or bonds.

There is another practical reason why asset protection trusts often are structured in such a way that they hold stock or limited partnership interests. This has to do with both asset protection and control. In the case of corporate stock, it is thought that the settlor can maintain a larger degree of control by remaining as an officer of the corporation. In the case of a private

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[257] Although a grantor trust need not file a Form 1041 or acquire a taxpayer identification number if its situs is United States and all of its assets are in the United States, it must file this form if the situs of the trust or any of its assets are not in the United States. *See,* Treas. Reg. section 1.671-4(b)(3). The settlor is required, even if the trust is considered domestic, to report his reversionary interest by filing Form 90.22-1 by June 30 each year following the close of the proceeding year during which such foreign account or accounts existed and had a combined value of more than $10,000 at any time during that year.

[258] *See,* section IV.F. *infra*.

[259] *See,* section I.D.8. *supra*.

corporation, the shares of which are owned by an asset protection trust, the settlor, whose interest in the corporation may have represented a major portion of his wealth before the contribution to the trust, may feel more comfortable if he remains in control. As long as there is not an event of duress, all formalities are observed and the transfer to the asset protection trust is old and cold and clearly non-fraudulent, the settlor should have no problem. However, as President of the corporation, the settlor may have certain control over assets which he could neither have nor exercise as a trustee.

In the case of a limited partnership the assets may receive even greater protection. In particular, a typical structure would be to make a corporation controlled by a relative of the settlor a general partner of a validly formed limited partnership in which the asset protection trust is a limited partner.[260]

If it is desired that the asset protection trust hold stock or limited partnership interests such entities can be formed first and be directly contributed to the asset protection trust without tax cost.[261] This transfer will not result in a dissolution of the partnership. Often this is the preferred settlement technique since the settlor never at any time loses control of his money or other assets. The other method of establishing this structure is to have the settlor transfer assets, including cash, to the trustee and then advise the trustee, through the Committee of Trust Advisors, that the assets should be contributed to a corporation in exchange for stock or to a partnership in exchange for a limited partnership interest. The contribution from the asset

[260] *See,* section III.A.1(b)(ii) *supra*.

[261] *See,* section IV.B.5 *supra*.

protection trust to the corporation in exchange for stock is not subject to United States tax because of I.R.C. section 351. Similarly, the transfer of assets to the limited partnership is not subject to tax because of I.R.C. section 721.

(b) Subchapter S corporation

A trust which is treated as a grantor trust pursuant to I.R.C. sections 671 through 679 and which is classified as a domestic trust can be a qualified Subchapter S shareholder under I.R.C. section 1361(c)(2)(A)(i). As such it may hold stock in a Subchapter S corporation. A foreign trust is not a qualified electing shareholder. The classification as a trust as foreign or domestic is purely a question of fact.[262] The IRS will not issue advance rulings on this issue.[263] Further, asset protection trusts are designed to be flexible and react quickly to changes in circumstances. If an event of duress occurred, which can be as simple as a creditor filing certain types of collection actions or a collection attorney in New York calling the trustee's office to make an inquiry or to check on an address for the delivery of "papers," the trustee in the Cook Islands is empowered to take certain actions which may instantly result in the trust being recharacterized as foreign. In particular, the trustee, acting pursuant to specific instructions in the trust indenture might on that same day remove the trust assets from their situs in the United States and remove the United States citizens or residents from their positions as either trustees or Members of the Committee of Trust Advisors. Administration and all accounting functions would also be immediately removed from the United States. The asset protection structure, because of its built in defense

[262] *See,* section IV.B.5 *supra*.

[263] Rev. Pro. 93-7, 1993-1 I.R.B. 170.

mechanisms, can result in the automatic change of the most important factors evaluated in connection with the classification of the trust. In particular, the situs of administration, trust corpus and the residence and nationality of trustees could be shifted out of the United States instantly and automatically, without the settlor even being aware of the fact. The trust, after these actions, would certainly be foreign and would no longer be qualified to be the shareholder of a Subchapter S corporation. The acts incumbent upon the trustee in connection with his asset protection responsibilities disqualify the asset protection trust as an entity qualified to hold Subchapter S stock. For this reason it is unwise for an asset protection trust to ever be purposefully structured to hold interests in Subchapter S corporations. It is also unwise for trustees to accept such interests.

6. Impact of I.R.C. section 679

The Tax Reform Act of 1976 added I.R.C. section 679. The purpose of this section is to tax the United States grantor of a foreign trust as the owner of the trust if the trust has a United States beneficiary. In the instant case this section is of no import to the settlor since the trust has been specifically structured so that the settlor is the owner of the trust under the grantor trust rules.[264] There are a number of circumstances where a settlor or potential settlor of an asset protection trust would want to carefully consider the impact of I.R.C. section 679. For example, if a United States citizen was planning to expatriate he would want to wait until the expatriation process was formally completed and he was no longer a resident of the United States before forming an asset protection trust. A corollary to this is the nonresident alien who is considering

[264] *See,* I.R.C. sections 671 to 678. *See also* section IV.B.2. *supra*.

the formation of an asset protection trust. This non-resident alien will want to complete the settlement process before becoming a U.S. resident. I.R.C. section 679 can be triggered by many other circumstances such as a nonresident alien beneficiary becoming a U.S. resident or even marrying a somebody who, under some circumstances, becomes a U.S. resident.[265]

C. Gift tax consequences

The asset protection trust should be designed so that there are no federal gift tax consequences on the initial transfer to the trust. This is done by carefully structuring the trust so that no transfers into the trust ever become a completed gift during the lifetime of the settlor.The only time a gift tax should be due in connection with a properly drafted trust is when the trustee actually makes a distribution to a beneficiary.

A gift tax, imposed by I.R.C. section 2501 is due "on the transfer of property by gift...by any individual." This tax is imposed "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible..."[266]

1. Transfers into trust - complete v. incomplete Gifts

The initial transfer into the trust would normally be a taxable event applying the general rules set forth in the proceeding paragraph; however, this general and all encompassing rule is tempered by Treasury Regulations section 25.2511-2(b) which sets forth a basic premise of gift

[265] For a good discussion of foreign trusts in general and I.R.C. section 679 in particular *see* Zimmerman, *Using Foreign Trusts in the Post 1976 Period: What Possibilities Remain?*, 47 J. Tax 12 (1977). *See also* Bittker and Lokken *supra* at section 82.2 and Zaritsky *supra* at A-10 and A-11.

[266] *See,* I.R.C. section 2511(a).

tax law which is that there is no gift unless and until a transfer is complete. These regulations provide in pertinent part:

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case.

Care must be take to assure that the settlor's asset protection trust is drafted so that the initial transfer and all later transfers to the trust by the settlor are incomplete gifts. This is best done by structuring the trust so that the settlor has the power, with the consent of the trustee and other members of the Committee of Trust Advisors to delete or modify disposition provisions to beneficiaries or add new persons or entities other than the settlor, his estate, or their creditors as beneficiaries of the estate, thereby varying the beneficiaries' contingent interests. The trustee, with the concurrence of the Committee of Trust Advisors, should have the power to distribute income or trust corpus but not pursuant to a" fixed or ascertainable standard." This is specifically contemplated by Treasury Regulations which provide: "A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary

power limited by a fixed or ascertainable standard."[267] Treasury Regulations further provide that: "A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having "an adverse interest in the disposition of the trust property or its income."[268] It logically follows that the Committee of Trust Advisors is, both collectively and individually, not an adverse party.

These Treasury Regulations have been expanded and clarified by many cases. It is well settled that there is no completed gift where the settlor retains the right, not in conjunction with an adverse party, to add or delete beneficiaries or to vary their interests.[269] As long as care is taken in crafting the terms of the asset protection trust, transfers to the trust should not be completed gifts and no Federal gift tax should be due on such transfer.

2. Transfers out of trust

Distributions from the trust of income or corpus to any beneficiary completes the gift.[270] The gift is reportable and taxable unless it is excluded by the $10,000 per donee rule of I.R.C. section 2503(b) or the medical and educational exclusion of I.R.C. section 2503(e).[271] The gift is

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[267] *See,* Treas. Reg. section 25.2511-2(c).

[268] *See,* Treas. Reg. section 25.2511-2(c). *See also,* I.R.C. sections 672(a) and 672(b).

[269] The power of the settlor to change the beneficiaries of trust principal was sufficient to render the initial transfer to the trust incomplete. This is true even if the beneficiaries are a limited group or class. *See, Higgins v. Commissioner*, 129 F.2d 237 (1st Cir. 1942).

[270] *See,* Treas. Reg. section 25.2511-2(f) and Priv. Ltr. Rul. 80-29-001.

[271] This portion of the paper assumes that a gift-splitting election was not made pursuant to I.R.C. section 2513(b).

neither reportable or taxable if it is made to a spouse, unless the spouse is not a United States citizen.[272]

Any distribution to the settlor upon termination of the grantor trust is a tax free return of previously taxed trust corpus. This is not a taxable event.[273]

D. Estate tax consequences

If, as discussed above, the transfers to the asset protection trust were incomplete gifts and the United States settlor of this asset protection trust dies without having renounced powers such that the gift is deemed to be completed during his lifetime, then the full value of the assets held by the asset protection trust on the death of the settlor will be included in such settlor's estate for federal estate tax purposes.[274] Distributions from the asset protection trust to persons other than the grantor made within three years of his death may be included in his estate under the reasoning of *Estate of Jalkut v. Commissioner*[275] in which the Tax Court held that distributions made by the trustee at a time that the trustee was authorized to distribute trust property to beneficiaries other than the decedent settlor should be included in the settlor's estate. The Tax Court reasoned that the transfers should be considered a relinquishment by the decedent through the trustee of his power to alter, amend, revoke or terminate the trust with respect to transferred assets. The Court reasoned further that because those amounts would have bœn includible in the

[272] I.R.C. section 2523(a).

[273] *See,* I.R.C. section 641 and Bittker and Lokken *supra* section 80.2.

[274] *See,* I.R.C. sections 2036 and 2038. *See also* Bittker and Lokken *supra*, chapter 125.

[275] 96 T.C. 675 (1991), *acq.*, 1991-2 C.B. 1.

settlor's estate under I.R.C. section 2038 if retained by the decedent, the gifts effected by the trustees were likewise includible under I.R.C. section 2035(d)(2).

E. Excise tax consequences

Any transfer by a United States citizen or resident to a foreign trust triggers an excise tax equal to 35 percent of the "gain."[276] I.R.C. section 1492 contains certain exceptions to this rule which are largely unhelpful to the settlor.[277] For many years, since the enactment of the much narrower predecessor to section 1491 in 1932, the Internal Revenue Service has maintained that this tax applied even if the transfer was to a foreign trust in which the United States person was treated as the grantor.[278] In 1987 the Internal Revenue Service reversed its position on section 1491 in Revenue Ruling 87-61 which ruled that the transfer of appreciated property to a foreign trust by a U.S. person properly classified as the owner under I.R.C. sections 671 to 679 is not subject to the excise tax under I.R.C. section 1491. The Internal Revenue Service reasoned that the U.S. person continued to own the property for income tax purposes and that the trust should be ignored.[279] This highly desirable result was reached by questionable logic as the Internal Revenue Service ruled that the grantor trust did not exist for all tax purposes (including estate

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[276] The tax is 35 percent of the "excess of-

(1) the fair market value of the property so transferred, over

(2) the sum of -

the adjusted basis (for determining gain) of such property in the hands of the transferor, plus

(B) the amount of the gain recognized to the transferor at the time of the transfer."

[277] *See,* Bittker and Lokken *supra* at paragraphs 68.6, 80.1 and 82.2.

[278] *See,* section IV.B.2. *supra*.

and gift tax law) and not just for the implementation of the excise tax as was required to reach the result.

Based upon the authority of Revenue Ruling 87-61[280] a section 1491 excise tax will not apply to the transfer of assets to the asset protection trust. In the event that the asset protection trust ceases to be a grantor trust, the I.R.C. section 1491 excise tax would be triggered.

F. Federal Filing Requirements for Asset Protection Trusts

Form 4789 - Currency Transaction Report[281]

All transfers of $10,000 or more by or through a bank or other financial institution are reported by the institution to the Department of Treasury on Internal Revenue Service Form 4789. Multiple recurrent transactions are often consolidated. Many banks have a regular practice of reporting deposits of $7,000 or more. Reports are due within 15 days on the transaction. Reports may be computer transferred to the IRS Detroit Computing Center. Civil and criminal penalties (up to $500,000 and ten years imprisonment) are provided for false or fraudulent returns.

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[279] Rev. Rul. 87-61, 1987-2 C.B. 11.

[280] I would like to know why this important exception to 1491 has not made it into the Code. Relying upon a revenue ruling as authority to disregard the specific provisions of a statute makes me uncomfortable; however, Revenue Ruling 87-61 is specific, unambiguous and constitutes good law. However, because this exception to I.R.C. section 1491 has been carved out by a Revenue Ruling, it provides a non-statutory tool which could be utilized to impede United States citizens or residents from utilizing asset protection trusts. All the Service would have to do is return to its pre-Revenue Ruling 87-61 position with respect to certain foreign trusts with asset protection qualities.

[281] *See,* section III.A.3(f)(ii) *supra*.

Form 8300 - Report of Cash Payments Over $10,000 Received in a Trade or Business[282]

Any person who, in connection with his trade or business, receives more than $10,000 in cash including foreign currency or monetary instruments is required to report the transaction to the Internal Revenue Service by I.R.C. section 6050I. This provision does not apply to financial institutions or other businesses (*i.e.,* car dealers) which have received a currency transaction clearance from the Internal Revenue Service. Civil and criminal sanctions apply for failure to file (I.R.C. section 6050I(f)(2)). This provision applies to foreign situs asset protection trusts which are considered to be domestic.

Customs Form 4790 - Report of International Transportation of Currency or Monetary Bearer Instruments

Any person who aids, counsels, commands, procures or requests the transfer of cash or bearer securities out of the United States in the amount of $10,000 or more on any one occasion must file form 4790 with the Internal Revenue Service. This report is not required to be filed if the transaction is effected through normal banking channels.

Deposit Account Records

All banks, savings and loans and other financial institutions in the United States are required by law to maintain a copy of signature deposit account records showing each transaction and a copy of all checks issued by the institution in excess of $100. These records are discoverable in any civil or criminal proceeding.

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[282] *See,* section IV.B.5. *supra*.

Form 3520 - Creation of or Transfers to Certain Foreign Trusts[283]

The settlor of a foreign trust must file Form 3520 with the Philadelphia Internal Revenue Service Center within 90 days of the creation of or transfer to any foreign situs trust which is not considered to be a United States resident. This Form 3520 calls for a great deal of information including the date the trust was formed, the date of transfer to the trust, the date of trust termination, distribution requirements, as well as the names, dates of birth, Social Security Numbers and address of each beneficiary. If a U.S. resident trust loses its residence (i.e. because of an event constituting duress),[284] this form must be filed. Failure to file this form is punished by civil (penalty of five percent of the corpus up to $1,000) and criminal ($25,000 fine and/or one year imprisonment) sanctions.

Form 926 - Return by U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership

The settlor must file a Form 926 with the Internal Revenue Service for the purpose of determining if a I.R.C. section 1491 excise tax is due. The form calls for information relating to the settlor and all beneficiaries including their name, address and social security numbers as well as information relating to the trust including the identification of the trustee and place of settlement. The form requires a computation of the excise tax or a reason why it is not due. If the foreign situs trust is a domestic resident this form is not required.

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[283] *See,* section IV.B.5. *supra*.

[284] *See,* section I.D.8. *supra*.

Form 5471 - Information Return of U.S. Persons with Respect to Certain Foreign Corporations

When a United States citizen or resident acquires a five percent or greater interest in a foreign corporation (or entity which would be treated as a corporation under United States law) then that citizen must disclose his ownership by filing Form 5471 with his return. Ownership is attributed through a trust. The same reporting requirement is imposed on any United States citizen or resident who acquires an interest in a foreign partnership.[285] Civil and criminal penalties apply for false or fraudulent filing.[286]

Form 3520-A - Annual Return of Foreign Trust with U.S. Beneficiaries

This form is required if the United States grantor of a foreign trust is arguably subject to tax under I.R.C. section 959. This form is required to be filed on April 15th for a calendar year grantor and, like Form 3520 must be filed with the Philadelphia Service Center. In addition to requesting complete information regarding the grantor and beneficiaries, including name, address, citizenship and social security number, the form requires the filing or an income statement and balance sheet for the trust. If the foreign situs trust is a United States resident this form need not be filed. Failure to file is punishable by civil (five percent of the trust corpus up to $1,000) and criminal ($25,000 and/or one year imprisonment) penalties.

[285] I.R.C. section 6046A.

[286] *See,* I.R.C. sections 6679 and 7023.

Form 1041 - U.S. Fiduciary Income Tax Return or Form 1040 NR - U.S. Nonresidents Income Tax Return

Each trustee and arguably the each member of the Committee of Trust Advisors must file a United States fiduciary income tax return if he or she derives any taxable income for the year or gross income of $600 or more. If the trust is a foreign trust the proper form is 1041NR, otherwise the proper form is 1041. The form requires the reporting of the income, deductions and credits attributable to the grantor as well as the grantor's name, address and social security number.

Form 56 - Notice of Continuing Fiduciary Relationship

Form 56 is attached to the fiduciaries first tax return filed, normally the 1041 NR or 1041). Attached to the Form 56 is normally a copy of the trust agreement. The form is signed by the trustee. Filing this form merely helps rebut any claim of fraudulent intent or concealment. Failure to file it in connection with a grantor trust is not punishable by civil or criminal sanctions.

Form TD F 90-22.1 - Report of Foreign Bank and Financial Accounts

Any United States citizen or resident who has custody, control or signature power over any foreign bank account must disclose the account to the government on Treasury Form TD F 90-22.1. These reports are supposedly confidential and not discoverable.

Form 1040 - U.S. Individual Income Tax Return of the Settlor

The settlor who is a United States citizen or resident must report his income from the grantor trust on his tax return, whether or not this income is actually distributed to him.

Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return

A United States gift tax return is required even though the gifts are not complete.[287] A certified copy of the trust instrument and the instrument of transfer must be attached.

APPENDIX A

COOK ISLANDS

International Trusts Act 1984, as amended[288]

[287] *See,* Treas. Reg. section 25.2511-2(c).

[288]. The International Trusts Act 1984 has been amended by the International Trusts Amendment Act 1985, the International Trust Amendment Act 1989, the International Trusts Amendment (No. 2) Act 1989 and the International Trusts Amendment Act 1991 which amendments are incorporated into this consolidation. This consolidation has been prepared by the author based on his careful review of the original sources and included amendments through July 1, 1993. However, the Cook Islands does not as yet publish an official consolidated version of the International Trusts Act 1984, as amended.

THE INTERNATIONAL TRUSTS ACT 1984

PART I

PRELIMINARY

PART II

MODIFICATION OF THE LAWS APPLICABLE TO INTERNATIONAL TRUSTS

PART III

REGISTRATION OF TRUSTS

PART IV

APPLICATION OF OTHER ACTS

PART V

MISCELLANEOUS

SCHEDULE

(THE FOLLOWING TEXT IS INTENTIONALLY OMITTED)