Asset Protection Planning (With Audit Checklist)

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A. Introduction

1. Litigation environment creates greater exposure to risk of loss.
   a. Expanded theories of liability (such as McDonald's coffee spill);
   b. Higher jury awards;
   c. Unpredictable judges.
2. Traditional forms of protection have become inadequate.
   a. Insurance:
      i. Exclusions;
      ii. Policy limits;
      iii. Solvency of insurer;
      iv. Policy lapses.
   b. Incorporation:
      i. Piercing corporate veil;
      ii. Shareholder and officer liability.
3. *Candidates For Asset Protection Planning*
   a. Professionals;

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b. Officers, directors, and fiduciaries;

c. Real estate owners with exposure to environmental claims;

d. Individuals exposed to lawsuits arising from claims alleging negligent acts, intentional torts (discrimination, harassment, and libel), or contractual claims;

e. Prenuptial alternative.

4. Asset protection concepts are not new:

a. Incorporation of business activities;

b. Formation of LLCs, LLPs, and LPs;

c. Offshore trusts used traditionally to avoid forced heirship or government expropriation;

d. Exemption and pre-bankruptcy planning.

5. Asset protection is part of an overall wealth preservation process, including:

a. Investment diversification;

b. Insurance adequacy;

c. Income tax planning;

d. Estate tax planning;

e. Wealth protection.

B. Fraudulent Conveyance Issues

1. *Law Varies By Jurisdiction.* Transfers proper in one state may be held improper elsewhere, but certain generally accepted principles govern creditors. Common law usually divides creditors into three categories:

a. *Present Creditors.* Those persons of whom the transferor has notice when making transfers.

b. *Subsequent Creditors.* Those persons against whom the transferor harbored an actual fraudulent intent when transferring assets, including creditors whose rights arose after the transfers, if the transferor then intended to proceed with his or her affairs in a fraudulent manner or with reckless disregard for the rights of others.

c. *Potential Future Creditors.* Those "nameless, faceless" persons of whom the transferor had no awareness when transfer was made.

2. Other statutory restrictions on transfers:

a. IRC §§7206 and 7212 (crime to conceal or hinder collection of tax);

b. Money Laundering Control Act of 1986, 18 U.S.C. §1956 and §1957 (transfer of proceeds of specified enumerated activities, such as Medicare fraud, are criminal offenses);

c. Crime Control Act of 1990, 18 U.S.C. §1032.

C. Traditional Forms Of Asset Protection

1. Transfers to spouse. "Poor man's" asset protection.
2. Corporate ownership.
3. Family limited partnerships.
4. Limited liability company.
5. Joint ownership of property. Tenancy by the entireties.
6. Exemption Planning:
   a. Homestead;
   b. Retirement plans;
   c. Life insurance;
   d. Annuities.

D. Domestic Trusts In General

1. Trusts separate legal ownership from beneficial ownership. Since a trust beneficiary does not generally have legal ownership of trust property (until a distribution is made), the property is free from the claims of the beneficiary's creditors.
2. Advantages include avoidance of probate, more efficient transfer of assets, confidentiality, and protection from beneficiary's creditors (including spousal claims).
3. *Disadvantages.* Under most state laws, the settlor's creditors can recover against trust assets if:
   a. The trust was funded as a result of a fraudulent conveyance;
   b. The settlor retained too much control (such as power to revoke or appoint property);
   c. The settlor retained a beneficial interest; or
   d. The trust is a sham.
4. Most states recognize the validity of spendthrift clauses that protect a beneficiary's interest from creditors' claims. Such clauses, however, are generally not enforceable with respect to a settlor who is a beneficiary, to the extent of such settlor's interest. Most states have statutes against self-settled trusts which provide that a settlor cannot create a trust to protect himself or herself from creditors. *See, e.g., Restatement (Second) of Trusts* §156 (1959). Asset protection available to beneficiaries of domestic trusts is dependent on three factors:
   a. Level of settlor's retention of control over trust.
   b. Extent of power of appointment available to beneficiaries.
   c. Extent of withdrawal or invasion rights provided to beneficiaries.
5. Maximum asset protection would be available to trust beneficiaries where trust provides the following:

a. Independent trustees.

b. Right to receive income or principal distributions only in trustee's discretion.

c. Trustee given power to make payment on behalf of beneficiaries rather than directly to them.

d. Trustee authorized to acquire assets for use of beneficiaries (for example, home and art).

e. Trustee given power to hold back distributions if distributions would be adverse to beneficiary's interest.

f. Power of appointment given to beneficiaries is limited.

g. Inclusion of additional sprinkling beneficiaries.

h. Inclusion of spendthrift provision or use of a trust situs that automatically provides for a spendthrift trust.

i. Assets that may create liability exposure to other trust property should be segregated into separate trusts or entities (such as LLCs). Trustees should be given authority to create separate trusts and entities to isolate such property. *See, e.g., Matter of Heller*, 161 Misc.2d 369, 613 N.Y.S.2d 809 (N.Y. Sur.Ct. 1994).

6. *Limitations On Spendthrift Trust Protection*

a. Internal Revenue Service. *See, e.g., Bank One Ohio Trust Co. v. United States*, 80 F.3d 173 (6th Cir. 1996).

b. Potentially involuntary tort creditors.

c. Child or spousal support.

d. Reciprocal trusts ineffective.

e. Self-settled trusts.

7. *Specific Trusts With Asset Protection Aspects*

a. Discretionary trust.

b. Support trusts. Distributions limited to health, support, and maintenance.

c. Credit shelter discretionary trusts.

d. Marital trusts limiting principal invasions.

e. Split interest trusts (such as CRTs, GRATs, and QPRTs).

8. Although trusts may not be protected from the settlor's creditors if the settlor retains a beneficial interest therein, planning opportunities should not be overlooked.

a. Trusts for the benefit of spouses and children will be protected from the settlor's creditors (provided that the trust funding was not a fraudulent conveyance) as well as the beneficiaries' creditors. If there is a divorce or the spouse predeceases, the settlor can thereupon become a discretionary beneficiary.

b. The settlor can retain a power of appointment over the trust to prevent the transfer from being a completed gift.

c. The settlor can retain an income interest only, which would protect the principal from creditors.

d. The settlor can give the trustee limited discretion to distribute principal to the settlor only for emergency needs or where the settlor has insufficient resources for support and maintenance. *See DiMaria v. Bank of Cal. Nat'l Ass'n,* 46 Cal.Rptr. 924 (Cal. Ct. App. 1965).

e. In some states a revocable trust may be used to avoid a spouse's right of election claims. *See, e.g., Cherniack v. Home Nat'l Bank and Trust Co. of Meriden,* 198 A.2d 58 (Conn. 1964).

E. Domestic Asset Protection Trusts

1. Ten states have enacted legislation providing spendthrift protection to a settlor-beneficiary of a discretionary trust (provided the transfer is not a fraudulent conveyance).

   a. Alaska;

   b. Delaware;

   c. Nevada;

   d. Missouri;

   e. Rhode Island;

   f. Utah;

   g. South Dakota;

   h. Tennessee;

   i. Wyoming;

   j. New Hampshire (effective January 1, 2009).

2. Okalahoma, pursuant to the Family Wealth Preservation Trust Act of June 9, 2004 (Okla.Stat. tit. 31, §10), permits an individual to create a trust with a bank or trust company located in Oklahoma (but not an individual resident of Oklahoma) for the benefit of his or her spouse, descendants, and any one or more IRC §501(c)(3) charities and to retain the right to revoke the trust without causing the trust to thereby be available to creditors. In addition, the law provides that no court shall have the authority to compel the settlor to exercise his or her power to revoke the trust. The law does, however, limit to $1 million of transferred assets plus any subsequent growth thereon as the amount that can thus be protected. The corpus of the trust must consist of assets in Oklahoma-based banks, real estate located in Oklahoma, and securities issued by Oklahoma-based companies (including corporations, LLCs, and LPs formed or domiciled in Oklahoma and having a principal place of business in Oklahoma).

3. *Summary Of Alaska Trust Law*

   a. The Alaska Trust Act (effective April 2, 1997) modified Alaska's previously undistinguished common-law body of trust law in an effort generally touted as making Alaska a domestic alternative to foreign situs asset protection trusts. A significant amendment was enacted on July 10, 2003.

b. In contrast to *Restatement (Second) of Trusts* §156(2), Alaska law (Alaska Stat. §34.40.110) permits a settlor to create a trust for his or her own benefit, which will be protected from the settlor's future creditors so long as:

i. The settlor does not retain the right to revoke or terminate the trust.

ii. The settlor was not in default by 30 days or more in making a child-support payment.

iii. The settlor's ability to receive distributions from the trust is within the discretion of the trustees rather than mandatory. The trustee, however, may permit a beneficiary the use of property, and the settlor may retain an annuity or unitrust interest in a charitable remainder trust. The settlor may also retain a right to receive a percentage of the trust each year not to exceed the unitrust amount provided under §643(b).

iv. The transfer of property to the trust was not intended to defraud creditors (that is, a fraudulent conveyance generally subject to a four-year statute of limitations under Alaska law).

v. Under Alaska Stat. §34.40.110 a creditor existing at the time the trust is created must bring suit within the later of four years from the transfer or one year after the transfer is, or reasonably could have been, discovered by the creditor if the creditor can demonstrate by a preponderance of evidence that the creditor asserted a specific claim against the settlor before the transfer or files another action within four years after the transfer against the settlor that asserts a claim based on an act or omission of the settlor that occurred before the transfer.

c. Alaska law (Alaska Stat. §13.36.310) prohibits a challenge to a trust (except as otherwise provided above) on the grounds "that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on a person by reason of a personal or business relationship with the settlor or by way of a marital or similar right."

d. The Alaska Trust Act also modified Alaska's common-law Rule Against Perpetuities to provide that, so long as the trustees have discretion to make current distributions to a trust beneficiary, the trust will not be invalid because it fails to vest within the normal perpetuities period.

e. A mere choice of law clause will not be sufficient to establish a trust as an "Alaska trust." Alaska law (Alaska Stat. §13.36.035) sets forth definitive statutory requirements for establishing a trust as a trust subject to Alaska's trust law:

i. At least one trustee must be a "qualified person" under Alaska Stat. §13.36.390(3), meaning that at least one trustee must be either a trust company or a bank with trust powers with its principal place of business in Alaska, or an individual resident of Alaska.

ii. Some of the trust assets must be deposited in Alaska, either in a checking or brokerage account, or other similar account located in Alaska.

iii. The Alaska trustee's duties must include both the obligation to maintain the trust's records and to prepare or arrange for the preparation of the trust's income tax returns, although neither of these requirements must be exclusive to the Alaska trustee.

iv. Part or all of the trust's administration must occur in Alaska, including the physical maintenance of the trust's records in Alaska.

f. Consistent with the foregoing requirements of Alaska Stat. §13.36.035, an Alaska trust may be settled by any person, regardless of whether he or she is domiciled in Alaska.

g. Alaska Stat. §§13.36.70 and 13.36.375 provide for the appointment of third-party trust protectors and trustee advisers without imposing fiduciary liability.

h. The settlor must provide an affidavit of solvency.

i. The Act (Alaska Stat. §34.40.110(e)) precludes a claim against a "trustee of the trust or against others involved in the preparation or funding of the trust for conspiracy to commit fraudulent conveyance, aiding and abetting a fraudulent conveyance, or participation in the trust transaction." It further provides: "Preparation or funding of the trust includes the preparation and funding of a limited partnership or a limited liability company if interests in the limited partnership or limited liability company are subsequently transferred to the trust. The creditor and other person prevented from asserting a cause of action or claim for relief are limited to recourse against the trust assets and the settlor to the extent allowed under [Alaska's fraudulent conveyance statute]."

4. *Review Of Delaware Trust Law*

a. The synopsis of Delaware's Act notes the purpose of the legislation is to allow settlors to reduce estate tax by excluding creditors' claims against self-settled trusts. The Act notes recent legislation in Alaska and "is intended to maintain Delaware's role as the most favored jurisdiction for the establishment of trusts."

b. Delaware law (12 Del.Code Ann. tit. 12, §3570 et seq.) applies to "qualified dispositions" made on or after July 1, 1997.

c. A qualified disposition is a disposition by or from a transferor to a trustee who (i) is a Delaware resident, bank, or institution authorized by Delaware law to act as a trustee and (ii) maintains or arranges for custody in Delaware of some or all of the trust corpus, maintains records (on an exclusive or nonexclusive basis), prepares or arranges for the preparation of fiduciary tax returns, or otherwise materially participates in the trust's administration.

d. A trust must be irrevocable but can include one or more of the following provisions:

i. Settlor may retain power to veto distributions.

ii. Settlor may retain a special power of appointment.

iii. Settlor may retain the right to:

(1) Current income distributions;

(2) Payments from a charitable remainder trust;

(3) Annual payments of up to 5 percent of the initial value of the trust or of its value as determined from time to time; or

(4) Principal distributions under an ascertainable standard (for example, health, maintenance, education, or support).

iv. Settlor may receive income, principal, or both in the sole discretion of a trustee.

v. Settlor may remove a trustee or adviser and appoint a new trustee or advisor (other than a person who is a related or subordinate party with respect to the transferor within the meaning of §672(c) of the Internal Revenue Code of 1986, 26 U.S.C. §672(c), and any successor provision thereto).

vi. Settlor may retain use of a residence held in a qualified personal residence trust ("QPRT").

e. Provided the transfer of property to the trust was not intended to hinder, delay, or defraud creditors (that is, a fraudulent conveyance), no action to enforce a judgment shall be brought for attachment against such qualified disposition.

i. Under §3572(b) of Del. Code tit. 12, a creditor existing at the time a transfer to a trust is made must commence an action to enforce a judgment within the later of four years or one year after the transfer was or could reasonably have been discovered by the creditor.

ii. If the creditor's claim arose after the transfer, the action must be brought within four years of the transfer.

(1) Subsection (a) of §3572 provides that a creditor whose claim arose after a qualified disposition can set the transfer aside only if that creditor proves that the transfer was made with actual intent to defraud (not merely to hinder or delay).

f. The Act provides that no action of any kind shall be brought against the trustee or against "any person involved in the counseling, drafting, preparation, execution or funding" of a trust that is the subject of a "qualified disposition."

g. Certain creditors may, however, avoid qualified dispositions:

i. Any person to whom the settlor is indebted on account of an agreement or court order for support, alimony, or property distribution in favor of a spouse, former spouse, or children. For purposes of this rule, however, a person is treated as a spouse or former spouse only if the person was married to the transferor at, or before, the time of the qualified disposition. Therefore if the debtor creates a Delaware asset protection trust prior to the marriage, he or she will be protected.

ii. Any person who suffers death, personal injury, or property damage on or before the qualified disposition, which death, personal injury, or property damage was caused by transferor or another person for whom transferor is liable.

h. In 2003, section 3572 was amended by the addition of a new subsection that has the effect of immediately terminating a trustee's authority upon the occurrence of another state court's attempt to exercise jurisdiction over a trustee if the court declines to apply Delaware's law with respect to the validity, construction, or administration of the trust. If the trust instrument does not provide for a successor trustee, the Delaware Court of Chancery would appoint a successor trustee, presumably one who would be subject to the Delaware court's jurisdiction only.

i. On June 30, 2005, the Act was amended to (i) permit the grantor to retain the right to receive annual payments of a fixed dollar amount not to exceed 5 percent of the initial value of the trust corpus; (ii) clarify that a qualified personal residence trust may include provisions requiring conversion to an annuity trust in the event the residence is sold; (iii) permit the grantor to receive reimbursement for income taxes paid on trust income, provided such payments are in the discretion of the trustee or trust adviser; (iv) permit a trust being redomiciled to Delaware to tack on the time during which it was located elsewhere for purposes of the statute of limitations regarding creditor claims (provided, however, that any general power of appointment that the settlor retained in the original trust is curtailed to a limited testamentary power); and (v) clarify that a creditor seeking to recover distributions made to a beneficiary, or to prevent a trustee from paying its fees and costs out of the trust, must prove by clear and convincing evidence that the beneficiary or trustee, as the case may be, acted in bad faith (except that, in the case of a beneficiary who is also the settlor, the creditor need only prove bad faith by a preponderance of the evidence).

5. *Review Of Nevada Trust Law*

a. Effective October 1, 1999, Nevada began allowing spendthrift protection for self-settled trusts, provided that they meet the following requirements as set forth in Nev.Rev.Stat. §166:

i. Trust must be irrevocable.

ii. Settlor is only a discretionary beneficiary.

iii. Transfer was not intended to hinder, delay, or defraud known creditors.

iv. Settlor may retain a veto power over distributions or hold a testamentary special power of appointment.

v. All or part of the property is in Nevada.

vi. All or part of the administration of the trust is performed in Nevada.

vii. At least one Nevada resident is a trustee and has powers that include maintaining records and preparing tax returns for the trust.

viii. A creditor may not bring an action with respect to property transferred to a spendthrift trust unless brought within two years after the transfer or six months after he or she discovers or reasonably should have discovered the transfer, whichever is later. If a person becomes a creditor after the transfer is made, he or she must bring the action with two years after the transfer.

6. *Review Of Missouri Legislation*

a. Missouri law provides that where the settlor is not the sole beneficiary of a trust and does not retain the power to revoke or amend the trust, or a portion of the income or principal, the trust will be protected from the settlor's creditors.

b. Section 456.5-504.1 provides: "A beneficiary's interest in a trust that is subject to the trustee's discretion does not constitute an interest in property or an enforceable right even if the discretion is expressed in the form of a standard of distribution or the beneficiary is then serving as a trustee or cotrustee. A creditor or other claimant may not attach present or future distributions from such

an interest or right, obtain an order from a court forcing the judicial sale of the interest or compelling the trustee to make distributions, or reach the interest or right by an other means, even if the trustee has abused the trustee's discretion.

c. Section 456.5-504(3) provides that, "[e]ven if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust, may obtain from a court an order attaching present or future trust income."

d. Section 456.5-505.3 provides: With respect to an irrevocable trust with a spendthrift provision, a spendthrift provision will prevent the settlor's creditors from satisfying claims from the trust assets except:

i. Where the conveyance of assets to the trust was fraudulent as to creditors pursuant to the provisions of chapter 428 Mo.Rev.Stat.; or

ii. To the extent of the settlor's beneficial interest in the trust assets, if at the time the trust became irrevocable:

(1) The settlor was the sole beneficiary of either the income or principal of the trust or retained the power to amend the trust; or

(2) The settlor was one of a class of beneficiaries and retained a right to receive a specific portion of the income or principal of the trust that was determinable solely from the provisions of the trust instrument

e. According to the Committee Report, "[t]he incorporation and reenactment of these statutory provisions giving settlor's [sic] a limited protection from creditors by virtue of a spendthrift clause in Section [456.5-505.3] is intended to overrule any holding that would render that portion of the statute meaningless . . . . MUTC section 456.5-505 altered the [Uniform Trust Code] provisions to incorporate Missouri's exception for protection of a settlor's retained discretionary interest as one of a class of beneficiaries that is currently contained in R.S.Mo. 456.080.3." Committee Report at 94.

7. *Review Of Rhode Island Legislation*

a. R.I.Gen. Laws §18-9.2 applies to "qualified dispositions" made after June 30, 1999. A qualified disposition is a transfer to a trust that is:

i. Irrevocable.

ii. Incorporates the laws of Rhode Island to govern the validity, construction, and administration of the trust.

iii. Contains a restriction on assignment of income or property.

iv. Wherein the transferor retains only:

(1) Power to veto distributions.

(2) Testamentary special power of appointment.

(3) Right to receive distributions in the sole discretion of trustee who is neither related nor subordinate.

b. The trustee must be a resident of Rhode Island (in the case of an individual) or authorized by Rhode Island law to act as a trustee (in the case of a nonindividual).

c. A creditor may not bring an action to avoid a qualified disposition if:

i. The creditor's claim arose before the transfer was made unless the action is brought within four years after the transfer or, if later, within one year after the transfer was or could reasonably have been discovered by the creditor; or

ii. The creditor's claim arose after the transfer, unless the action is brought within four years after the transfer is made.

8. *Review Of Utah Legislation*

a. The Utah legislation, which is effective for trusts created on or after May 5, 2003, is set forth in Utah Code Ann. §25-6-14, et seq.

b. The trust must meet the following requirements:

i. At least one trustee must be a trust company resident in Utah.

ii. Applies only to transfers of personal property or interests therein.

iii. The settlor does not retain the right to revoke the trust.

iv. The settlor may only receive income or principal at the discretion of the trustee.

v. The settlor was not in default by 30 days or more under a child-support order.

c. A creditor existing at the time the trust is settled must bring suit within the later of three years after the transfer is made or one year after the transfer is or reasonably could have been discovered. A creditor arising after a transfer has two years from the transfer date to bring suit.

d. The Act provides protection from a claim against a trustee or adviser for conspiracy to commit a fraudulent conveyance or aiding and abetting a fraudulent conveyance.

e. A trust will be subject to Utah's governing law if:

i. Some or all of the assets are deposited in the state in a bank, brokerage, or trust company;

ii. The trust has at least one resident trustee; and

iii. Some administration (for example, maintaining trust records or arranging for tax return preparation) occurs in the state.

f. The Act modifies the state's Rule Against Perpetuities to provide for a 1,000-year period.

9. *Review Of South Dakota Legislation*

a. The "Act to Authorize Qualified Dispositions," S.D. Codified Laws §55-16-1 et seq., is effective for trusts settled on or after July 1, 2005.

b. The trust must meet the following requirements:

i. Governing law must be South Dakota.

ii. Trust must be irrevocable.

iii. Trust must prohibit voluntary or involuntary assignment.

iv. Grantor may retain the following:

(1) Power to veto trust distributions;

(2) Limited testamentary power of appointment;

(3) Current income distributions;

(4) Payments from a charitable remainder trust;

(5) Annual payments of up to 5 percent of the initial value of the trust or of its value as determined from time to time;

(6) Principal distributions under an ascertainable standard (for example, health, maintenance, education, or support);

(7) The right to receive income, principal, or both in the sole discretion of a trustee who is neither the settlor nor a related or subordinated party of the transferor, IRC §672(c);

(8) Power to remove and appoint trustees; and

(9) Retained use of residence in a QPRT.

c. The trustee must be a resident of the state or a bank or trust company that maintains or arranges for custody in the state of some or all of the property, maintains records on an exclusive or nonexclusive basis, prepares or arranges for the preparation of the tax returns, or otherwise materially participates in the administration of the trust.

d. The Act permits the appointment of a nonresident trust adviser, including a trust protector, who may hold one or more trust powers. The settlor may be designated as a trust adviser.

e. The Act provides protection to trustees and any person involved in "counseling, drafting, preparation, execution or funding of a trust" from claims of creditors.

f. Transfers are subject to provisions of the Uniform Fraudulent Transfer Act.

g. Certain creditors may, however, avoid qualified dispositions:

i. Any person to whom the settlor is indebted on account of an agreement or court order for support, alimony, or property distribution in favor of a spouse, former spouse, or children; or

ii. Any person who suffers death, personal injury, or property damage on or before the qualified disposition, which death, personal injury, or property damage was caused by transferor or another person for whom transferor is liable.

10. *Review Of Tennessee Legislation*

a. Effective July 1, 2007, the Tennessee Investment Services Act of 2007, Tenn. Code Ann. §35-16-101 et seq., began permitting the creation of self-settled spendthrift trusts (called Investment Services Trusts in Tennessee) under Tennessee law.

b. An Investment Services Trust ("IST") means an instrument appointing a qualified trustee or qualified trustees for the property that is the subject of a disposition, which instrument:

i. Expressly incorporates the law of Tennessee as governing its validity, construction, and administration;

ii. Is irrevocable; and

iii. Provides that the interest of the transferor in trust property or the income from trust property may not be transferred, assigned, pledged, or mortgaged, whether voluntarily or involuntarily.

c. A "qualified trustee" is a natural person who is a resident of Tennessee (other than the settlor) or a person authorized by the law of Tennessee to act as a trustee and who maintains or arranges for custody in Tennessee of the property of the trust, maintains records for the trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of required income tax returns for the trust, or otherwise materially participates in the administration of the trust.

d. The settlor is permitted to retain one or more of the following rights in an Investment Services Trust:

i. Direct the investment of the Investment Services Trust's assets;

ii. Receive trust income;

iii. Request up to 5 percent of trust principal annually;

iv. Receive additional distributions of principal based on the discretion of the trustee or another appointed adviser;

v. Live in a home owned by the trust;

vi. Veto distributions to any other permissible beneficiary;

vii. Direct the distribution of the trust assets upon death to any one or more persons other than the settlor's creditors, estate, or creditors of the settlor's estate; and

viii. Remove the trustee and other trust advisers and appoint their successors, provided they are not related or subordinate to the settlor.

e. At the creation of the Investment Services Trust, the settlor is required to provide an affidavit under oath that must include, among other things, a statement that by creating the trust he or she does not intend to defraud a creditor and that he or she does not have any pending or threatened court action against him or her other than those identified in the affidavit.

f. The Investment Services Trust does not provide asset protection for assets transferred to it until four years after the transfer. At that time, the settlor's creditors are prevented from seizing the assets of the IST to satisfy claims against the settlor.

11. *Review Of Wyoming Legislation*

a. Wyoming Stat. Ann. §4-10-510 provides for the creation of a "qualified spendthrift trust" (that is a self-settled spendthrift trust) with a "qualified trustee" for "qualified trust property."

b. A "qualified spendthrift trust" requires:

i. The trust instrument to state that the trust is a qualified spendthrift trust under §4-10-510.

ii. The trust instrument to expressly incorporate the law of Wyoming to govern the validity, construction, and administration of the trust.

iii. The trust instrument to provide that the interest of the settlor in the trust income or principal, or both, is held subject to a spendthrift provision.

iv. The trust to be irrevocable, but a trust instrument will not be deemed to be revocable because of the inclusion of one or more of the following:

(1) The settlor's power to veto trust distributions;

(2) An inter vivos or testamentary limited or general power of appointment held by the settlor;

(3) The settlor's potential or actual receipt of income;

(4) The settlor's potential or actual receipt of income or principal from a charitable remainder trust;

(5) The settlor's receipt each year of up to 5 percent of the initial value of the trust or of its value as determined from time to time;

(6) The settlor's potential or actual receipt or use of principal under an ascertainable standard (for example, health, maintenance, education, or support);

(7) The settlor's right to add or remove a trustee, trust protector, or trust adviser and to appoint a new trustee, trust protector, or trust adviser, other than the settlor;

(8) The settlor's potential or actual use of real property held under a QPRT;

(9) A trust protector has the power to add beneficiaries to the trust who are not the trust protector, the estate of the trust protector, the creditors of the trust protector, or the heirs of the trust protector; and

(10) The settlor's service as an investment adviser to the trust.

c. "Qualified trust property" is real property, personal property, and interests in real or personal property and all gains, appreciation, and income thereon that are the subject of a "qualified transfer" or are acquired with the proceeds of property of a qualified transfer.

d. Qualified trust property is not protected under the following circumstances:

i. Against any claim by any person to whom a settlor is indebted on account of an agreement or order of court for the payment of child support.

(1) If the qualified trust property is listed on an application or financial statement used to obtain or maintain credit other than for the benefit of the qualified spendthrift trust.

iii. Property of a qualified spendthrift trust that was transferred by a settlor who received the property by a fraudulent transfer.

e. Transfers are also subject to provisions of the Uniform Fraudulent Transfer Act.

f. A "qualified trustee" is a natural person (other than the settlor) who is a resident of Wyoming or a person authorized by the law of Wyoming to act as a trustee, who maintains or arranges for custody in Wyoming of some or all of the qualified trust property, maintains records for the qualified spendthrift trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of fiduciary income tax returns for the qualified spendthrift trust, or otherwise materially participates in the administration of the qualified spendthrift trust.

g. A creditor cannot make any claim or bring any cause of action against the trustee, trust protector, trust adviser, or other fiduciary of the trust or against any person involved in the counseling, drafting, administration, preparation, execution, or funding of the trust.

h. The settlor must provide an affidavit of solvency containing the statements set forth in §4-10-523.

12. *Review Of New Hampshire Legislation*

a. New Hampshire Rev. Stat. Ann. §§564-D:1–D:18 are substantially similar to the South Dakota provisions and are effective for dispositions to qualified trusts after January 1, 2009.

F. Foreign Situs Trusts

1. *Overview*

a. Historically used to avoid forced heirship and government expropriation.

b. Places assets out of reach by U.S. courts.

c. Requires creditors to litigate in a foreign jurisdiction under the foreign jurisdiction's laws and system.

d. Does not rely on secrecy or concealment to be effective.

2. Similar to domestic trust, as it can act as will substitute or supplement to avoid probate and maintain confidentiality, and to handle the settlor's affairs in the event of disability or unavailability.

3. Provides procedural, substantive, and psychological barriers to creditors because many jurisdictions do not honor U.S. judgments, making trust assets beyond the practical reach of most creditors.

4. Trusts separate legal ownership from beneficial ownership. Since a trust beneficiary does not generally have legal ownership of trust property (until a distribution is made), the property is free from the claims of the beneficiary's creditors.

5. Carefully selected trust law provides a greater degree of substantive certainty in planning.

a. Most critical aspect in selecting a jurisdiction is fraudulent conveyance law. Formerly most English jurisdictions followed Statute of Elizabeth, passed in 1571, and there was no period of limitation within which to bring an action.

b. Fairly recently a number of jurisdictions have passed legislation specifically addressing asset protection trusts created by foreign settlors, which substantially reduces the reach of the Statute of Elizabeth.

c. Other factors to consider in selecting jurisdiction:

i. Need for a stable responsible foreign trustee in stable country.

ii. Effect of tax laws.

iii. Existing language barriers.

iv. Availability of professional trust services and modern telecommunications facilities.

v. Solidity of reputation in global financial community.

vi. Statutory framework of jurisdictions, including short statute of limitations period for challenging a trust.

vii. Provisions for protector status.

viii. Whether and to what extent a settlor can be a beneficiary and a protector.

(1) Settlor's ability to retain enjoyment or control, while still protecting assets, is more expansive than in the United States.

ix. Whether foreign judgments are recognized.

x. Standard of proof required to succeed in a fraudulent conveyance action.

(1) No jurisdiction will protect transfers made by an insolvent grantor.

xi. Access to courts and legal fees required to litigate offshore.

xii. The following jurisdictions have enacted favorable asset protection trust legislation, some offering greater protection than others. *See* Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts* 23 Estate Planning 65 (February 1996).

(1) Anguilla
(2) Antigua
(3) Bahamas
(4) Barbados
(5) Belize
(6 Bermuda
(7) Cayman Islands
(8) Cook Islands
(9) Cyprus
(10) Gibraltar
(11) Labuan
(12) Marshall Islands
(13) Mauritius
(14) Nevis
(15) Niue
(16) St. Vincent
(17) St. Lucia
(18) Seychelles
(19) Turks and Caicos

6. *Overview Of Cook Islands*

a. *General Characteristics*

i. The Cook Islands are located in the south Pacific Ocean, east of Australia and south of Hawaii.

ii. The capital is Rarotonga, with a modern international airport and regular air service to Los Angeles, Hawaii, Tahiti, Fiji, and Auckland.

iii. The islands are remote from the world's major financial centers but have modern communications systems. Their time zone is only three hours behind Pacific Standard Time.

iv. The Cook Islands are self-governing. Their closest link is with New Zealand, and they use New Zealand currency. They have been independent since 1965.

v. English is the official language, and there is a common-law legal system. Appeals of court decisions are brought before the Privy Council in England.

b. *Confidentiality.* The Cook Islands' banking laws mandate secrecy about client information with penalty of one year imprisonment for a violation.

c. *Taxes*

i. The Cook Islands are a "no-tax" jurisdiction.

ii. So long as businesses organized in the Cook Islands do not conduct business there, they are exempt from tax.

d. *Fraudulent Disposition And Trusts.* The Cook Islands enacted comprehensive trust legislation in the International Trusts Amendment Act of 1989 (effective September 8, 1989), which has since been amended several times, most recently in 1999.

i. The legislation addresses "International Trusts" ("ITs") and the effect thereon of fraudulent dispositions and bankruptcy.

ii. With respect to fraudulent dispositions, a creditor seeking to set aside a disposition must prove beyond a reasonable doubt that:

(1) The disposition was made with an intent to defraud that particular creditor; and

(2) The transferor was rendered insolvent by the transfer. If the fair market value of the settlor's property after the transfer to the trust exceeds the value of the creditor's claim at the time of the transfer, there is no intent to defraud.

iii. If the creditor meets this burden, the transfer is not void or voidable. Instead the transferor must pay the creditor's claim from property that would have been subject to its claim but for the transfer, that is, from property in respect of which the action is brought.

iv. Furthermore, the statute expressly states that an IT will not be void by virtue of the settlor's bankruptcy.

v. Recent amendments (in 1997 and 1999) also contain limitation provisions.

(1) If a creditor's cause of action accrues more than two years before a transfer to an IT, the transfer will be deemed not to be fraudulent, unless proceedings in respect of that cause of action had been commenced at the date of the relevant transfer.

(2) Also if a creditor fails to bring an action within one year from the date the transfer to an IT, the action is barred.

(3) Furthermore, if the transfer (whether initial or subsequent) to an IT occurs before a creditor's cause of action accrues, such a disposition will not be fraudulent as to that creditor. A "cause of action" is defined as the first cause of action capable of assertion against a settlor.

(4) For redomiciled trusts, the limitations period commences at the time of original transfer, even when the transfer was to an offshore center other than the Cook Islands.

(5) Where a creditor is successful in setting aside a transfer, the court must disregard any punitive damage award from the creditor's claim.

vi. Another section of the legislation sets forth certain circumstances that will not be deemed "badges of fraud." Fraudulent intent cannot be imputed from:

(1) Transfer to an IT within two years of the accrual of a creditor's cause of action;

(2) Retention of powers or benefits by the settlor; or

(3) Designation of the settlor as a beneficiary, trustee, or protector.

e. *Trusts*

i. Retained powers and benefits are explicitly addressed by statute. An IT cannot be "declared void or be affected in any way" because the settlor:

(1) Has the power to revoke or amend the trust, to dispose of trust property, or to remove or appoint a trustee or protector;

(2) Retains, possesses, or acquires any benefit, interest, or property from the trust; or

(3) Is a beneficiary, trustee, or protector.

ii. The Rule Against Perpetuities has been repealed. Alternatively, an IT may use a period at the option of the parties.

iii. Other provisions of the legislation make selection of Cook Islands law binding and conclusive, ensure that an IT is not subject to forced heirship laws of other countries, require nonrecognition of a foreign judgment against an IT, its settlor, trustee, and protector, recognize the powers of a trust protector, and permit trustees to delegate certain powers to others.

iv. The Act also provides that community property transferred to an IT retains its character as community property.

f. *Other Consideration*

i. Based on the author's review of commonly selected offshore jurisdictions, the Cook Islands have one of the most comprehensive bodies of statutory law governing trusts and fraudulent conveyances. The level of comfort one obtains with such statutory certainty should be a factor to weigh against the inconvenience of traveling to this venue.

7. Choice of law clause should generally be upheld if parties have minimum contacts with jurisdiction selected.

   a. Analogous to a New York business incorporated in Delaware or a trust that chooses to apply South Dakota law to avoid the Rule Against Perpetuities.

   b. Appointing a foreign trustee should satisfy minimum contact requirement even where assets are not physically offshore.

   c. *Restatement (Second) of Conflicts of Laws* §273 provides that:

"Whether the interest of a beneficiary of [an inter vivos] trust of movables is assignable by him and can be reached by his creditor is determined …by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered and otherwise by the local law of the state to which the administration of the trust is most substantially related."

   d. *See In re Renard*, 437 N.Y.S.2d 860 (N.Y. Sur. Ct. 1981). *Cf. In re Portnoy, In Re Brooks,* and *In Re Lawrence,* infra. For a detailed analysis of conflict of law rules as they relate to self-settled trusts, *see* Rothschild, Rubin, and Blattmachr, *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch*," 32 Vander.J.Transnat'l L. 763 (1999).

8. *Foreign Trustee*

   a. Trust can have one or more trustees with at least one trustee resident in the foreign jurisdiction.

   b. Duties of offshore trustee may be nominal initially, but trust would usually provide that foreign trustee has power to remove domestic trustees in the event of a threat to assets or against the trust were to develop.

   c. Trust generally allows trustees to invest trust assets anywhere in the world, so trustee can direct that assets be transferred to financial institution (as custodian) in another jurisdiction, such as Zurich or London.

   d. Foreign trustee should have no presence in the United States to avoid jurisdiction by U.S. court.

9. *"Protectors" Who Act As Watchdogs Over Trustees*

   a. A protector has veto powers over a trustee and can discharge a trustee.

   b. In some jurisdictions the settlor may be a protector and may have certain veto powers over the trustees, including power to remove and replace trustees and to veto investment and distribution decisions without such powers affecting creditor protection status. But vesting the settlor with such powers may expose the settlor to contempt. *See Federal Trade Comm'n v. Affordable Media*, infra.

   c. Since protector's power to veto certain trustee decisions is a negative power (as opposed to an affirmative power to initiate action), protector cannot be compelled by a court to submit assets to its control.

10. *Nonasset Protection Reasons For Offshore Trusts*

    a. A client may wish to create a long-term dynasty trust not limited by Rule Against Perpetuities. Some jurisdictions permit trusts to last 100 years or more.

    b. Although the trust is tax neutral during the settlor's lifetime, under the grantor trust rules it becomes a nongrantor foreign trust at the settlor's death. This can present tax opportunities not available to domestic trusts.

    c. Avoidance of forced heirship rules (such as right of election provisions).

    d. Properly structured foreign situs trust can invest in companies that for one reason or another do not wish to comply with SEC filing requirements (and therefore are otherwise off limits to U.S. investors).

        i. Offshore hedge funds.

        ii. Foreign variable life insurance.

    e. Foreign trusts are also used to diversify risk, avoid exchange controls, avoid government expropriation, and maintain privacy.

11. *Trust Structure*

    a. Irrevocable to avoid possibility a creditor could have the settlor compelled to revoke it. May provide for reversion to the settlor after a period of time, provided no creditor claims exist that provide for reversion.

    b. Settlor's interest as beneficiary should be discretionary.

    c. Settlor should retain a limited power of appointment if a completed gift is to be avoided.

    d. Provision should be made for a protector and the powers of protector.

    e. Give power to remove trustees located in jurisdictions where certain events occur (such as any threat to trust or trustees).

12. *Tax Issues*

    a. *Residence Of Trust.* IRC §§7701(a)(30) and (31)(B) provide that a trust is a foreign trust unless two criteria are met:

        i. A court within the United States must be able to exercise primary supervision over the administration of the trust; and

        ii. One or more U.S. persons have the authority to control all substantial decisions of the trust.

    b. A properly structured foreign situs trust should not be taxed any differently than a domestic trust. The only distinction, in the end, will be that the reporting requirements will be triggered.

    c. Even if the trust were a foreign trust for tax purposes, it would be treated as a grantor trust under IRC §679 if the settlor is a U.S. person and the trust has U.S. beneficiaries (in addition to the regular grantor trust provisions contained in IRC §§671-677). The transferor will generally be treated as the owner of the percentage of the foreign trust attributable to the property transferred, as long as the trust has any U.S. beneficiaries and the settlor is living.

d. *Gift And Estate Tax Aspects*

i. Retained power of appointment renders transfer an incomplete gift. Treas.Reg. §25.2511-2(b).

ii. Incomplete gifts will be included in settlor's estate upon death.

iii. Can contain standard credit shelter or bypass trust language and also direct trustee to qualify other property for the marital deduction.

iv. Can preserve step-up in basis benefit on death if included in estate.

v. If clients reside in a community property state, consider preserving double step-up in basis by using a jurisdiction that recognizes community property, such as the Cook Islands.

vi. If it is desired to make the gift complete, the settlor should not retain any power of appointment.

e. IRC §684 tax on transfers of appreciated assets is not applicable with respect to transfers to foreign grantor trusts. But, if upon death, the trust, which becomes a nongrantor trust, is not includable in the settlor's estate, IRC §684 will apply immediately before death.

f. By structuring the trust to meet the requirements of a domestic trust for U.S. tax reporting purposes, one can nevertheless provide that the trust be governed by foreign law for purposes of interpretation, validity, and governing law. Such a trust, referred to as a hybrid trust, provides that a U.S. person controls all substantive decisions, and during periods of such U.S. person's control a U.S. court has primary supervision over administration of the trust.

g. *Tax Return Filing Requirements*

i. Even though gift is incomplete, a gift tax return must be filed. Treas.Reg. §25.6019-3(a).

ii. Since trust is a grantor trust, a Form 1041, United States Income Tax Return for Estates and Trusts, must be filed annually. The return, however, need disclose only that it is a grantor trust and that all income and deductions will be reported on settlor's Form 1040.

iii. If trust is deemed a U.S. trust for tax-reporting purposes, no other filing requirements. On Form 1040, Schedule B, taxpayer may answer "no" to question of whether he or she was a grantor or transferor to a foreign trust.

iv. Once a trust is deemed to be a foreign trust, however, additional forms must be filed. These include Department of the Treasury Form TD F 90-22.1 and IRS Forms 56, 1040NR, 3520, 3520-A, and 4970.

v. Most offshore jurisdictions do not impose income, gift, estate, excise, capital gain, or any other form of tax whatsoever if the trust is properly structured and the settlor is a nonresident of such jurisdiction.

h. See Priv.Ltr.Rul. 95-36-002 (May 12, 1995), which analyzed an offshore trust/partnership structure, determining it to be gift tax and income tax neutral.

13. *Combining Foreign Trust With Limited Liability Company*

a. Maximizes both flexibility and protection.

b. When first established, transferor conveys assets to LLC in exchange for LLC interest, which is then transferred to the trust, allowing the manager/settlor to maintain control over LLC's assets.

c. Once threat appears, foreign trustee has power to remove manager (to protect manager from any potential court order) and, as sole member of the LLC, move LLC assets offshore.

d. A member of the LLC can make election to be a disregarded entity by filing Form 8832. Single member LLCs electing to be disregarded entities must file annually on Form 8858.

14. *Asset Transfer Considerations*

a. Generally, liquid assets are best and least complicated to transfer offshore.

b. If client wishes to protect nonliquid assets (such as real estate and business interests) it may be possible to borrow out most of the equity using the property as collateral and moving the loan proceeds offshore.

c. Pension assets, including IRAs, would generally not be transferred since doing so would result in immediate income taxation and possible penalties for premature withdrawals. But ERISA-qualified plans and IRAs are protected. In many states non-ERISA plans (such as Keoghs with only one participant) are protected under state exemption statutes.

d. Statutory provisions restrict transfers of professional corporation stock. To strip the equity out of the corporation, however, the grantor can borrow against corporate assets and transfer the proceeds to the partnership or trust.

e. "Nest egg" transfer for businessperson who must retain adequate assets to obtain bank loans versus other clients who might transfer all their property.

f. Creation of several partnerships or LLCs so that inherent liabilities of certain assets do not taint other assets, for example, real estate.

15. *Export The Assets v. Import The Law*

a. Exporting assets to foreign jurisdiction under control of foreign trustee.

b. Importing the law:

i. Assets transferred to settlor-controlled LLC or FLP remain in United States until threat arises.

ii. May subject settlor to civil contempt.

iii. U.S. court may have jurisdiction over foreign trust due to situs of assets remaining in United States. *See Nastro v. D'Onofrio*, 263 F.Supp.2d 446 (D. Conn. 2003).

16. *Foreign v. Domestic*

a. Foreign trusts offer more substantive barriers to creditors since a U.S. judgment may not be enforceable offshore, whereas the U.S. Constitution generally requires state courts to enforce other states' judgments.

b. Will settlor's designation of what state or foreign country's laws govern the trust be respected? Or will a creditor's rights be determined by the state's governmental interest or "significant relationship" with the settlor? *See, e.g., In re Portnoy*, 201 B.R. 685 (S.D.N.Y. Bkrtcy. Ct. 1996), infra, and *B.V. Brooks*, 217 B.R. 98 (D.Conn. Bkrcy Ct. 1998).

c. Consider appointment of a domestic trustee resident in a state that recognizes self-settled trusts to act with a foreign trustee.

17. *How Much Protection Is Necessary?*

a. Some client situations warrant greater sophistication and complexity resulting in higher costs.

b. Continuum beginning with transferring assets to a spouse (at minimum cost) and proceeding through a series of alternatives offering more certainty and flexibility until reaching offshore trust or foreign LLC contribution (at greatest cost).

18. *Costs*

a. In addition to legal fees, client will incur annual fees to offshore trustee of $1,500 to $4,000 depending on jurisdiction. Once trust is created only other ongoing costs are those for preparing the trust income tax returns.

b. Fees paid to establish asset protection trust and administrative fees paid to operate it should, if reasonable, be deductible under IRC §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."

c. Client should assess level of protection desired and consider annual cost to be similar to that of a single premium liability policy.

i. Cost/benefit analysis.

ii. Typical client has at least $1 million in assets to protect.

iii. Clients who place great value on peace of mind will be better able to justify more sophisticated techniques.

iv. Offshore trust on a stand-alone basis, where settlor is neither a protector nor a beneficiary; but client must give up control, which as a practical matter most clients would prefer not to do.

v. *Nature And Location Of Assets Owned By LLC Or Trust.* If client uses the LLC/trust technique generally there is no need, initially, to transfer assets offshore.

vi. In the author's experience, fewer than 5 percent of clients creating such vehicles have been targeted by creditors, and therefore these structures merely serve a similar purpose to that of insurance policies.

vii. When a creditor attack is imminent, however, a decision will have to be made to remove assets from danger of being seized. At this time assets can be liquidated and moved to another jurisdiction.

19. *Other Practical Concerns*

a. Possibility that a creditor may bring legal action against planner under various theories. Possibility that a client may have misrepresented his or her liabilities or that an aggressive creditor may name planner as a co-conspirator to gain some leverage in litigation. *See, e.g., Morganroth & Morganroth v. Norris, McLaughlin*, 331 F.3d 406 (3d Cir. 2003). Planner must protect himself or herself by properly advising clients that there are limits to protecting assets, demanding full disclosure, obtaining affidavits of solvency, and most importantly knowing the client.

b. Similarly, a New Jersey Court held that an attorney who advised his client that it was lawful if the client transferred his property to his wife prior to defaulting on a loan was subject to a civil conspiracy claim. *Banco Popular N. Am. v. Gandi*, (N.J.Super.Ct.App.Div. 2003), *aff'd in part, rev'd in part*, 876 A.2d 253 (N.J. 2005). The issue was whether the attorney participated in the conspiracy by offering defendant legal advice. Generally, an attorney may be charged with conspiracy if he or she is an active participant in the client's unlawful activity. In general, a lawyer is not liable for a client's tort unless the lawyer assisted the client through conduct itself tortious or gave substantial assistance to the client knowing the client's conduct to be tortious. *Restatement (Second) of Torts* §876.

c. Since asset protection planning must be implemented when there are no legal claims on the horizon, the planner has the difficult task of motivating a client to take action before a fear becomes a nightmare.

d. How will the filing of bankruptcy affect the creditor protection of self-settled trusts?

i. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added a provision that will deem a transfer to a self-settled trust to be a fraudulent transfer if made within 10 years of filing a bankruptcy petition if the transfer is made with fraudulent intent to hinder, delay, or defraud existing or future creditors.

ii. Should the settlor's interest as a beneficiary "spring up" only after 10 years? Alternatively, should the trust be settled offshore for the first 10 years and then be redomiciled onshore?

iii. Does the Act legitimize self-settled trusts that have been existent for more than 10 years? Or will the forum state still apply its own laws?

G. Summary Of Provisions Of New Bankruptcy Act Affecting The Wealthy

1. The passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") has significantly changed the landscape of wealth preservation strategies in the bankruptcy context. These changes are primarily in the areas of the homestead exemption, retirement plan assets, fraudulent transfers, and self-settled trusts.

a. *Homestead Exemption*

i. Responding to some bankruptcy debtors' abuses of the liberal homestead exemptions allowed by a number of states, the Act attempts to curb the availability of the exemption in the bankruptcy context.

ii. Under prior law, domicile for bankruptcy exemption purposes was determined based on where the debtor resided during the 180 days prior to filing the petition. The Act expands the period gen-

erally to two years. Furthermore, the homestead exemption will now be limited to $125,000 if the debtor acquired the homestead within 40 months prior to the filing of the petition. This limitation, however, does not apply to any amount transferred from the debtor's previous principal residence, which was acquired before the 40-month period, if it was located in the same state as the current residence.

(1) In the first reported case involving the homestead exemption, the Bankruptcy Court in Arizona held that the $125,000 limitation where the debtor acquired his residence within the 40-month period only applies in states that allow an election to opt out of the federal exemptions, noting that Congress may need to amend this provision to apply to "non-opt-out" states. *In re McNabb*, 2326 B.R. 785 (D.Ariz.Bkrtcy. Ct. 2005).

iii. The Act also provides that the value of the homestead exemption is reduced to the extent that such value is attributable to nonexempt property that the debtor "disposed of" in the 10-year period preceding the petition date with the intent to hinder, delay, or defraud a creditor. Of course, the question of whether or not there is actual intent in a given situation will become an issue in many situations.

iv. The homestead exemption also will be limited to $125,000 if the debtor (a) has been convicted of a felony, which under the circumstances indicates that the bankruptcy filing was abusive or (b) owes a debt arising from (i) a violation of securities laws, (ii) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of registered securities, (iii) RICO violations, or (iv) a crime, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding five years. Significantly, this limitation does not apply to the extent that the amount of the relevant property interest is reasonably necessary for the support of the debtor and any dependent of the debtor.

b. *Retirement Plan Assets*

i. Although as a general rule, the Act attempts to curtail abuses of the bankruptcy law by debtors and is generally pro-creditor; in the area of retirement plan assets the effect of the Act is decidedly "pro-debtor." Indeed, it significantly expands the potential for use of exemptions for retirement plan assets.

ii. The Act provides an express exemption for retirement accounts that are tax-exempt under IRC §§ 401, 403, 408, 408A, 414, 457, or 501(a). This includes not only ERISA plan accounts (which have been held by the Supreme Court to be exempt) but also traditional IRAs and Roth IRAs. In addition, the exemption applies whether the debtor elects state exemptions or federal exemptions. A very significant exception, however, is that the exemption is limited to $1 million, not including amounts attributable to qualified rollovers, with respect to (a) Roth IRAs and (b) traditional IRAs other than simplified employee pensions ("SEPs") under IRC §408(k) and SIMPLE retirement accounts under IRC §408(p). Thus an individual may claim as exempt up to $1 million in traditional IRA and Roth IRA accounts, and to the extent that the IRAs were funded through qualified rollovers the exemption is unlimited.

iii. The Act further provides that a rollover from one exempt account to another exempt account will not cause a loss of exemption. In addition, a distribution that is an eligible rollover distribution

under Code §402(c) or that has been rolled over into another exempt plan within 60 days does not lose its exemption. There is apparently no such continuing exemption for minimum required distributions once they are paid out. The Act, while not repealing the need-based exemption limitation provided for under Bankruptcy Code §522(d)(10)(E), in effect renders it applicable only in limited situations.

iv. The Act provides additional statutory protection to retirement plans that are exempt from taxation under certain Code sections. If the plan has received a favorable determination letter that is in effect on the petition filing date, the plan funds will be presumed to be exempt. If there has been no determination letter received, the funds are exempt provided no prior determination to the contrary has been made and (i) the plan is in substantial compliance with the Code or (ii) the fund fails to be in substantial compliance and the debtor is not "materially responsible" for such failure.

c. *Fraudulent Transfers And Transfers To Self-Settled Trusts*

i. Prior to the enactment of the Act, the Bankruptcy Code allowed a bankruptcy trustee to avoid any fraudulent transfer of the debtor that was made within one year prior to the filing of the petition. The Act extends that period to two years prior to the filing of the petition.

ii. The Act creates a new rule with regard to transfers to self-settled trusts by adding Bankruptcy Code §548(e), which provides for a longer claw-back of any transfer made by the debtor to a "self-settled trust or similar device" if the debtor is a beneficiary and made the transfer with actual intent to "hinder, delay or defraud any entity to which the debtor was indebted or to which the debtor ...became...indebted [thereafter]." As a result of the perceived abuse by those engaged in securities fraud, the Act specifically provides that a transfer "includes" a transfer made in anticipation of a money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by, any violation of state or federal securities laws or securities fraud.

iii. The intent-to-defraud language is virtually identical to the language permitting the avoidance of general fraudulent transfers. Thus, courts may interpret the meaning of the new provision based on existing case law.

iv. Although the legislative history of the provision indicates that the intent of this provision was to target fraudulent transfers by those persons involved in securities violations, the provision as enacted is not limited to such transfers. In addition, the Act's use of the phrase "self-settled trust or similar device" would seem to significantly extend the provision's reach. Conceivably, it may include entities, such as limited liability companies and even retirement plans, in which the settlor retains a beneficial interest.

H. Effectiveness Of And Challenges To Offshore Trusts

1. The effectiveness of any asset protection plan is determined by the results ultimately achieved. That is, in the final analysis, how long and at what cost will the client be subject to litigation and to what extent has the client protected the assets from loss.

2. In the real world plaintiffs must weigh the heavy costs of litigation against the likelihood of successful recovery. If, as a result of availing oneself of certain techniques, the debtor is in a better position to settle the dispute at considerably less cost, then the benefits of asset protection are realized.

3. The few reported decisions that involve settlors who have created offshore trusts offer insight into how the courts, both in the United States and abroad, view these structures.

   a. *In re 515 South Orange Grove Owners v. Orange Grove Partners*, brought in the Cook Islands in 1994, involved a California real estate developer against whom a suit was brought in 1992 in California and a judgment of $5 million was awarded in 1994. During 1993 and 1994 the defendants settled a trust in the Cook Islands and transferred assets thereto. The creditors obtained a *Mareva* injunction (similar to a TRO) ex parte. The author has been advised that this case settled. It may not have been difficult, however, for the creditor to have satisfied its burden to prove a fraudulent conveyance beyond a reasonable doubt under the timing stated.

   b. In *In re Brown*, 1996 WL 33657614 (D.Alaska Mar. 11, 1996), the court determined that the Belize trust created by the debtor was a sham, and therefore the assets of the trust were included in the debtor's bankruptcy estate. The court's decision was based on several factors including the failure to execute any trust documents and the debtor's retention of control over the trust assets.

   c. In *In re Portnoy*, 201 B.R. 685 (S.D.N.Y.Bkrtcy.Ct. Oct. 7, 1996), Mr. Portnoy transferred over $1 million to a Jersey trust "when he knew his personal guarantee was about to be called." Judge Brozman noted that the trust was created after Mr. Portnoy signed the guarantee and misrepresented, during settlement discussions (prior to bankruptcy filing), that he had incurred large expenses for cancer treatments and had no assets remaining to satisfy the debt. Mr. Portnoy also disclosed that his salary was being deposited into his wife's account. The court denied a discharge, noting that the debtor's actions demonstrated intent to defraud his creditor. There are reports that this matter settled.

   d. In the case of *In re B.V. Brooks*, 217 B.R. 98 (D.Conn.Bkrtcy.Ct. 1998), the issue before the court was again whether to apply domestic (in this case Connecticut) law or foreign law to the spendthrift trust exemption under the Bankruptcy Code. Citing *Portnoy* as precedent and following another seemingly result-oriented analysis of conflict of law rules, the court found the assets of the debtor's two trusts includable in the debtor's bankruptcy estate notwithstanding the fact that the trusts were valid spendthrift trusts under the laws of Bermuda and Jersey, Channel Islands. Although very little of the case's factual background was actually reported, the Bankruptcy Court did note that the debtor/settlor was the primary beneficiary of each of the trusts and had the right to receive all of the income. In addition, the unreported facts apparently caused the court to perceive the funding of the trusts as fraudulent since the court twice characterized the debtor's acts in creating the trusts as a "scheme." This perception was likely buttressed by the timing of the case since the trusts were funded in 1990, and an involuntary bankruptcy petition was filed against the debtor the following year.

   e. *In re Stephan Jay Lawrence*, 227 B.R. 907 (S.D.Fla.Bkrtcy.Ct. 1998), following a 42-month arbitration and just 66 days before an award in excess of U.S. $20 million was entered against him, the debtor funded an offshore trust, citing first the law of Jersey, Channel Islands, and about a month

later the law of Mauritius, as governing. Citing both *Portnoy* and *B.V. Brooks,* the Bankruptcy Court found that the sole purpose of the trust was to shield the debtor's assets from a creditor that "was about to obtain a staggering $20 Million arbitration award against him" and that "[t]he timing of the trust's creation is further evidence of this intent." The court also found the debtor's testimony before the court to have not been credible (and on several occasions perjurious) and that the debtor was "shockingly less than candid" with the court. The court, therefore, entered judgment against the debtor, thereby denying him a discharge in bankruptcy. Subsequently the bankruptcy trustee moved to hold the debtor in contempt if he did not repatriate the funds. In September 1999 the court found Lawrence in contempt (*In re Lawrence*, 238 B.R. 498, 500 (S.D.Fla.Bkrtcy.Ct. 1999), which finding was affirmed by the U.S. District Court in a de novo review. *In re Lawrence*, 251 B.R. 630 (S.D.Fla.Bkrtcy.Ct. 2000), *aff'd,* 279 F.3d 1294 (11th Cir. 2002).

i. Generally, impossibility of performance is a complete defense to a charge of coercive civil contempt. *United States v. Rylander*, 460 U.S. 752 (1983). Certain lower courts, however, have suggested that an exception exists where the impossibility is self-created within a nexus of time of the anticipated judgment. Accordingly, the court in *In re Lawrence* affirmed the civil contempt order.

f. *Federal Trade Comm'n v. Affordable Media LLC,* 179 F.3d. 1228 (9th Cir. 1999). Although the facts in this case (colloquially known as the "Anderson" case after its individual defendants) were as bad as, if not worse than, those in any of the foregoing cases, the court never reached any issues of trust validity or conflict of laws. Instead the court tangled with the settlors' alleged contempt of court in failing, pursuant to a preliminary injunction, to repatriate trust assets that had been invested in the trust's name offshore. Specifically, the settlors, who were also co-trustees of their own trust, as well as the trust protectors, were ordered to instruct their foreign co-trustee to repatriate more than $6 million in profits collected under an alleged Ponzi-type investment scheme. The "anti-duress" clause in the trust agreement resulted in their removal as trustees and ensured that the assets would not be repatriated pursuant to the court's order. When the assets were not timely repatriated, the settlors were held in civil contempt for failing to comply with the court order and jailed pending repatriation of the assets. After the FTC lost several rounds in the Cook Islands, the case was ultimately settled for $1.2 million.

i. In finding the Andersons in civil contempt, the district court rejected the Andersons' impossibility defense, specifically finding that the Andersons in the judgment of the court were in control of the trust since the trust instrument provided the protectors with the exclusive power to determine what constituted an event of duress.

g. Yet another case in which the timing was suspect is *Bank of America v. Brian Weese,* No. 03-C-01-001892 (Cir.Ct. Baltimore County 2001). After the creditor commenced litigation in the Cook Islands within their statute of limitations, the settlors settled the matter due to the Cook Islands Court's ruling that their attorneys' files were not protected by privilege under an exception to privilege relating to fraudulent transfers.

h. *Breitenstine v. Breitenstine*, 62 P.3d 587 (Wyo. 2002). After the sale of his family business, H took his share of the proceeds and deposited them into marital accounts for the benefit of both parties. H wanted to move offshore to protect the assets, so the family moved to the Bahamas. The parties

separated for a time and then reconciled. The following month after the reconciliation, H received another sum of money from his mother. Later that same year, H created the Breitenstine Family Trust and transferred a substantial portion of the marital assets to the trust. A year later, the parties separated again, and W filed for divorce. She withdrew the divorce, but several months later the parties separated for the final time. During that time, and up to until the equitable distribution hearing, H continued to make transfers of property to the Family Trust. There was no question that the source of the funds was H's inherited property and gifts from his parents. Those monies accounted for substantially all of the marital estate. Nevertheless, it was held (and affirmed on appeal) that the monies deposited into the Family Trust were assets subject to equitable distribution. While H contends the court should not have awarded a 50 percent distribution of those assets to W because the source funds were inherited, the court found that it was authorized to look to other factors to distribute inherited assets; included are: respective merits of the parties' cases, full and fair disclosure by the parties, and the parties' own handling of the funds once they were inherited. Here, H lied about his assets and failed to produce an accounting of the trust; H secreted other assets, setting up protection trusts and dummy corporations; and W and children were living in a diminished lifestyle while H continued to live well.

i. *United States v. Grant*, 2005 U.S.Dist. LEXIS 22440 (S.D.Fla. Sept. 2, 2005). In 1983 and 1984 Raymond Grant created a Bermuda trust and a Jersey, Channel Islands, trust. Raymond was the beneficiary of the Bermuda trust, and his wife, Arline Grant, was the beneficiary of the Jersey trust. In 1991 and 1993 the IRS assessed millions of dollars in back taxes against the Grants for the years 1977 through 1982, and 1984 through 1987. In 2003 judgment was entered against the Grants for more than $36 million, and a motion was made to order Arline to repatriate the trust funds. Arline had the power to remove and replace any acting trustee. The court set forth its query in simple terms: "[I]s this a trust over which the beneficiary lacks any control, such that the beneficiary is simply that and nothing more, and regardless of what she does or says, she lacks the power to repatriate these assets to the United States? — or, does the beneficiary retain such control that she has the power vested in her in some way by the terms of the trust to repatriate the corpus? If she has such power, then this asset is no different from any other asset." Although the court found that "by giving Arline Grant total unreviewable authority over discharge and appointment of the Trustees, she in actuality controls the corpus of the trust," in a 2008 decision reviewing evidence that Arline took steps to have the trustees remit the funds or resign in favor of a US trustee, which were unsuccessful, the court denied the government's motion to hold Arline in contempt as her impossibility to comply was a complete defense to contempt. *See United States v. Raymond Grant and Arline Grant,* 2008 U.S.Dist. LEXIS 51332 (S.D.Fla. May 27, 2008).

j. *Federal Trade Comm'n v. Ameridebt, Inc.*, 373 F.Supp.2d 558 (D.Md. 2005). In this case, the defendants allegedly operated a "nonprofit" credit counseling service but defrauded consumers with debt problems by offering to fashion debt payment plans for them and then deducting fees from payments the consumers made under the plans without disclosing those deductions to the consumers. The Federal Trade Commission sought a preliminary injunction appointing a receiver, freezing the defendants' assets, requiring an accounting, and directing the defendants to repatriate to the receiver assets that were transferred offshore. The FTC alleged that since the time when the defendants be-

came aware of the investigation that led to the lawsuit the defendants had been actively dissipating their assets by making transfers to close friends and relatives, to trusts (both domestic and offshore), and by living a lavish lifestyle. In particular, less than two months after the FTC served two of the defendant companies with Civil Investigative Demands, one of the individual defendants set up domestic and offshore asset protection trusts. Presented with this set of egregious circumstances, the court granted the motion for preliminary injunction, appointing a receiver, freezing the defendants' assets, requiring an accounting of assets, and directing the defendants to repatriate to the receiver assets that were transferred offshore. With regard to the latter aspect of the injunction, the court noted that if the defendant violates the order and "fails to repatriate assets in the trusts, the FTC may move for contempt, at which point Defendants will be free to argue the impossibility of performance, an argument the Court may or may not find persuasive."

k. *Nastro v. D'Onofrio*, 263 F.Supp.2d 446 (D.Conn. 2003). The plaintiff obtained a $2.1 million judgment against the defendant for misappropriation of their formerly co-owned company's funds. Two weeks later, the defendant transferred $650,000 worth of stock and membership interests in Connecticut companies (of which he was either the 100 percent owner or 50 percent owner) to an irrevocable spendthrift trust in Jersey, Channel Islands, for the benefit of his wife and children. The plaintiff asserted, inter alia, that the transfer was fraudulent under Connecticut's Uniform Fraudulent Transfer Act. The plaintiff also argued that the defendant's attorney and the attorney's firm should be held liable for participating in the fraudulent transfer. The court dismissed the claims against the Jersey, Channel Islands, trustee, holding that there was no basis to exercise personal jurisdiction over it because the Jersey, Channel Islands, trustee had insufficient contacts with Connecticut. Further, the court ruled that there was no basis to exercise jurisdiction over the trust assets since they consisted of "certificated" securities and, under Connecticut's version of the Uniform Commercial Code, the situs of a certificated security is the place where the certificate is located (here Jersey, Channel Islands). This is the case "[e]ven though the companies and, presumably, the companies' assets are located in Connecticut." The court, however, granted plaintiff's preliminary injunction, enjoining the Connecticut companies from registering any further transfers of stock held by the trust and from transferring any assets to the defendant, his family, or the trust during the pendency of the litigation. The court found that the plaintiff satisfied his twin burdens of showing that he will suffer irreparable harm and that there are sufficiently serious questions on the merits. The first prong was satisfied since there was the possibility that the defendant could take further action to place the assets beyond the reach of the court. The second prong was satisfied since there was evidence that the defendant transferred his interests in the Connecticut companies without consideration and was thereby rendered insolvent (which, under Connecticut's Uniform Fraudulent Conveyance Act, would render the transfers fraudulent). The court also dismissed the claims against the attorney and his law firm, noting that there is no Connecticut authority for the validity of a cause of action against an attorney for aiding a fraudulent transfer. The court further observed that, in connection with liability under the Connecticut Unfair Trade Practices Act, the Connecticut Supreme Court stated that providing a cause of action under that Act for the actions of an opponent's attorney "would stand the attorney-client relationship on its head and would compromise an attorney's duty of undivided loyalty to his or her client and thwart the exercise of the attorney's independent professional judgment on his or her client's behalf."

l. *Banco Popular N. Am. v. Gandi*, 876 A.2d 253 (N.J. 2005). Suresh Gandi operated two Burger King franchises and one Arby's franchise. He held each of these franchises through separate holding companies of which he was the sole shareholder. One of the holding companies took out a $500,000 loan from Banco Popular. Gandi executed a personal guaranty with regard to the loan. In connection with an unrelated dispute with Arby's, Gandi retained an attorney, Richard Freedman, to represent him. Freedman allegedly advised Gandi to transfer all his assets to his wife so that they would be beyond Arby's reach. Freedman prepared the transfer documentation. A few months after the transfer, Banco Popular issued two more loans to Gandi's holding companies. The first was a $15,000 loan for which Gandi executed a guaranty. In spite of the earlier asset transfer, Gandi represented in the guaranty that he "has not . . . dispose[d] of all or substantially all of Guarantor's assets." He also stated that "no event has occurred which may adversely affect Guarantor's financial condition." The second loan was for $750,000 for which, again, Gandi executed a guaranty. The guaranty stated that he must maintain a minimum net worth of $950,000. In addition to negotiating the guaranty and loan, Freedman issued an opinion letter in which he stated: "After due investigation, we are unaware of any material matter contrary to the representations and warranties of the Borrower or the Guarantor contained in the Loan Documents." After Gandi defaulted on all of the loans, the bank obtained a $1.25 million judgment against him, and then filed a fraudulent transfer action against him and his wife. When Gandi testified at a deposition that Freedman advised him to make the transfers, the bank joined Freedman to the action as a defendant, alleging breach of duty to the bank, conspiracy to defraud Gandi's creditors, common-law fraud, negligence, creditor fraud, and ethical violations. After various dismissals and reinstatements of the claims in the lower courts, the New Jersey Supreme Court held that for the attorney to be liable to third parties, the attorney's actions must be intended to induce a specific third party's reliance on his or her representations. The court noted that, in aiding Gandi in the asset transfer, not only did Freedman make no representation to the bank seeking to cause reliance, the entire transaction was in fact intended to be (and was) carried out without the bank's knowledge. Therefore, there was no duty owed to the bank. In contrast, Freedman's representations in the loan negotiations and opinion letter were intended to induce reliance. Therefore the bank's claims against Freedman in that connection were permitted to proceed.

m. *Kendall v. Turner (In re Turner)*, 335 B.R. 140 (N.D.Cal.Bkrtcy.Ct. 2005), *modified*, 345 B.R. 674 (N.D. Cal. Bkrtcy. 2006) In this apparently result-oriented decision, the Bankruptcy Court concluded that the bankruptcy trustee was entitled to avoid the transfer of the debtor's home to a Nevada LLC and the subsequent transfer of the home to the debtor's wife. The court also ruled that the debtor's discharge should be denied. The debtor was a medical school graduate who was the subject of a number of complaints related to his practice and had been convicted of a misdemeanor (while practicing medicine on probation) based on an incident involving a patient. Around the time that a lawsuit was filed in connection with a separate unrelated course of conduct, later found to be tortious, relating to the plaintiff, the debtor set up a Nevada LLC that was owned 99 percent by a Bahamas trust and 1 percent by a Nevada corporation. Before judgment was entered, the debtor and his wife transferred their home to the LLC. After the plaintiff filed a fraudulent transfer action and attempted to execute a writ of execution against the house, the LLC recorded a deed transferring the home to the debtor's wife (purportedly to "confirm" that the home was the wife's

separate property and thereby alleviate alleged marital problems). The debtor subsequently filed for bankruptcy. In finding that the transfers were fraudulent, the court noted the "badges of fraud" that were present: all of the transfers were to insiders; the debtor retained possession and control of the home after the transfers; the debtor had been sued before most of the transfers took place; no consideration was received for the transfers; and the debtor was rendered insolvent by the transfers. Mildly disturbing, however, was the court's dismissal of the Nevada LLC, although it was likely persuaded by the particularly egregious facts of the case. After noting that "'Asset Protection' is not illegal and is honored by the law if done for a legitimate purpose," the court stated: "[A]n entity or series of entities may not be created with no business purpose and personal assets transferred to them with no relationship to any business purpose, simply as a means of shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice." It is unclear if the court would have made that observation if the structure had been set up with "no clouds on the horizon."

n. As many of these cases illustrate, "bad facts make bad law." Based on the facts presented, the trusts were created after the debt was incurred, and accordingly the court in each instance reached the right decision. Notwithstanding the results obtained (and without condoning such transfers), the debtors apparently benefited by their wrongful transfers. In the end, the best results will be obtained where trusts are settled sufficiently in advance and properly structured and administered.

    i. A decision recognizing the validity of a foreign trust arose in the context of a divorce proceeding. In *Riechers v. Riechers,* 679 N.Y.S.2d 233 (N.Y.Sup.Ct1998), *aff'd*, 701 N.Y.S.2d 113 (N.Y. App. Div. 1999), defendant husband settled an irrevocable trust in the Cook Islands in 1992 as a result of three medical malpractice lawsuits filed against him. His wife sued for divorce in 1994. The court in its decision wrote: "Assuming arguendo, that this Court had jurisdiction over the corpus of the Riechers Family Trust, which it does not, a cause of action would not lie to set aside the trust since the trust was established for the legitimate purpose of protecting family assets for the benefit of the Riechers family members."

o. At the end of the day, however, an offshore trust's effectiveness as a tool to thwart future creditors will most likely not depend on whether a U.S. court gives credence to the application of foreign trust law when adjudicating a claim against the settlor. Provided that the trust's assets are located offshore (whether that be in the jurisdiction of the trust's governing law or an established financial center such as Switzerland or Luxembourg), a creditor with a U.S. judgment will still be faced with significant hurdles before actually being able to levy on any of the trust's assets. In fact, since some jurisdictions will not recognize foreign judgments, the creditor may be forced to relitigate its entire case against the trust. Moreover, in some jurisdictions the statute of limitations on fraudulent conveyance claims may be as little as two years (which period is likely to have already expired by the time suit is brought in that jurisdiction). Finally, aside from the United States, most common-law jurisdictions (such as those jurisdictions that recognize the trust concept) (i) do not allow attorneys to take matters based on a contingency fee and (ii) provide that the losing party to a lawsuit must pay all the victor's expenses, including attorneys' fees. Combined with an evidentiary standard in some jurisdictions requiring proof beyond a reasonable doubt on fraudulent conveyance claims, assets held in a foreign trust may, in the end, be unreachable notwithstanding the fact of a U.S.

judgment. At the very least, the process may prove prohibitively expensive for a creditor when the potential reward is so uncertain.

I. New Trends In Asset Protection With Emphasis On Estate Planning

1. *Introduction*

a. Under the law of most states, a creditor of the settlor of a trust can reach the trust property to the maximum extent that the trustees may distribute the property to the settlor. *Restatement (Second) of Trusts* §156(2).

b. Most states limit the term of a trust so that it cannot continue to exist beyond the Rule Against Perpetuities period (generally no later than 21 years after the death of an individual then living or 90 years after the trust's creation).

c. To attract trust business, 25 states have repealed the Rule Against Perpetuities thereby encouraging dynasty trusts. Of those states, Alaska, Arizona, Delaware, Florida, Ohio, and South Dakota also do not impose a state income tax on trust income.

d. Numerous foreign jurisdictions have enacted legislation that prevents creditors from reaching the trust's assets unless the transfer was a fraudulent conveyance. It is reported that over $300 billion in assets have been transferred to foreign trusts by U.S. persons.

e. Recent legislation in nine states expands the turf war by providing estate planning opportunities with shades of asset protection.

2. *Analysis Of IRS Rulings And Court Decisions*

a. *Estate Tax Inclusion*

i. IRC §2036 provides that a transferor's gross estate includes the value of any transferred property over which the transferor retained the right to possession, enjoyment, or income for a period not ascertainable without reference to his or her life.

ii. A gift is incomplete in every instance in which "the donor reserves any power over its disposition." Treas.Reg. §25.2511-2.

iii. Since, under *Restatement (Second) of Trusts* §156(2), a settlor's creditors can reach trust property to the maximum extent that the trustees may distribute the property to the settlor, the settlor is deemed to have retained rights to the property within the meaning of IRC §2036 and §2511. *See, e.g., Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986), *Outwin v. Comm'r*, 76 T.C. 153 (1981), and *Paolozzi v. Comm'r*, 23 T.C. 182 (1954).

b. *Completed Gifts*

i. "If and when the [settlor's] dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a state where the [settlor's] creditors cannot reach the trust assets, then the gift is complete for federal gift tax purposes under the rules set forth in §25.2511-2 of the Regulations." Rev.Rul. 76-103, 1976-1 C.B. 293.

ii. Where "the [settlor] cannot require that any of the trust's assets be distributed to the [settlor] nor can the creditors of the [settlor] reach any of the trust's assets," the settlor has parted with dominion and control so as to have made a completed gift of the assets transferred to the trust. Rev. Rul. 77-378, 1977-2 C.B. 347.

iii. Private Letter Ruling 93-32-006 (not precedential) applies the foregoing rules to a foreign situs asset protection trust of which the settlor and the settlor's family were discretionary beneficiaries. The settlor's transfer to the foreign situs trust was deemed by the IRS to be a completed gift and, therefore, outside of the settlor's taxable estate because under the laws governing the trust the settlor's creditors could not attach the trust assets.

iv. Private Letter Ruling 98-37-007 (not precedential) applies to an Alaska trust in which the settlor was among the class of beneficiaries. The IRS held the transfer to be a completed gift but refused to rule on whether the assets in the trust would be includable in the settlor's estate at death because of the possibility of an implied agreement with the trustee to make distribution upon the settlor's demand.

3. *Structuring Trusts For Estate Planning Benefits*

a. *Introduction*

i. Basic objective of estate planning is to minimize estate, gift, and generation-skipping transfer taxes to the greatest extent possible while remaining true to the client's dispositive wishes.

ii. An estate planner's ability to minimize transfer taxes may be frustrated by the client's desire to retain control over or access to his or her assets during lifetime.

iii. A properly structured, self-settled, spendthrift trust ("APT") provides a viable solution to a client's desire to be able to minimize transfer taxes without putting his or her assets forever out of reach in the event of an emergency need.

iv. As an added benefit, property held in trust will avoid the delay, expense, and publicity involved in transferring property at death pursuant to a probate proceeding.

v. Since assets held in trust will enjoy a greater degree of creditor protection than assets retained in the settlor's individual name, a transfer to an APT will actually enhance the likelihood that the assets will be available to the settlor in case of some future emergency need.

b. *Minimizing Estate And Generation-Skipping Transfer Taxes*

i. A settlor can make an inter vivos transfer of the gift tax annual exclusion amount to an APT to gradually reduce the size of his or her taxable estate without incurring any transfer tax or reducing his or her unified credit.

(1) To have a transfer to an APT come under the IRC §2503 gift tax exclusion, the transfer must be of a "present interest" under IRC §2503(b). This can be accomplished by the inclusion of "Crummey" powers in the trust agreement.

ii. A settlor could make an inter vivos gift of his or her remaining IRC §2010 applicable exemption amount.

(1) No current transfer tax liability.

(2) Removal of subsequent appreciation from settlor's estate.

(3) The loss of the IRC §1015 "stepped-up" basis is more than compensated for by the overall tax savings inherent in the differential between the maximum 45 percent estate (and generation-skipping transfer) tax rate and the maximum 15 percent capital gains tax rate.

iii. Gifts in excess of the applicable exemption amount (in particular, gifts aggregating the IRC §2631 generation-skipping transfer tax exemption amount of $2 million) are advisable if the settlor can afford to pay the current gift tax since inter vivos gifts are, in effect, one-third more tax advantageous than testamentary bequests.

iv. Any gift tax paid will further reduce the settlor's taxable estate (provided the settlor lives three years).

v. An allocation of the settlor's $2 million generation-skipping transfer tax exemption to a transfer to trust will exempt the entire transfer of property and all future appreciation thereon from generation-skipping transfer tax.

c. *Drafting Considerations*

i. *Trustee Selection.* Trust must have at least a resident trustee, but settlor could appoint others (for example, an advisory committee) to make investment or distribution decisions. Trustee should not be related or subservient to settlor.

ii. *Trust Protector.* Settlor should not be protector. Protector can have power to discharge trustees, make certain trust amendments if necessary, and so forth.

iii. Change of situs provision allows for subsequent changes if laws or circumstances change.

iv. Other asset protection provisions, such as anti-duress clauses and flee clauses, can be incorporated into the trust.

v. *Distribution Guidelines*. Consider incentive provisions conditioned on earned income and distributions to beneficiary's spouse while married.

vi. Termination powers given to trustee if continuation not in beneficiary's best interests.

vii. Spendthrift provision to protect trust assets from beneficiary's creditors or former spouses.

d. *Other Considerations*

i. The trust agreement should maximize the trust's ability to escape future transfer taxation by providing for the retention of assets for the beneficiaries' use and enjoyment of the property in trust rather than mandating distributions upon the beneficiaries attaining set ages.

ii. All subsequent appreciation on the $1 million will be free from both estate and generation-skipping transfer tax for so long as the property remains in trust.

iii. Certain domestic asset protection trust jurisdictions have no state income tax. Once the settlor dies, assets retained in trust will, therefore, pay only federal income tax.

iv. Retaining assets in an APT ensures that beneficiaries' trust interests will not be seized by third-party creditors or ex-spouses.

v. In conjunction with the repeal of the Rule Against Perpetuities, the trust can continue to accrue all of the foregoing benefits in perpetuity.

vi. Trustees should be independent of the settlor (optimally banks or trust companies should be used) to ensure that the trustees' "discretionary" power to distribute trust assets to the settlor is respected by the IRS and not considered to be a "sham" by reason of any prearranged understanding between the parties.

vii. Trust should include a "checks and balances" system via an independent but reliable "trust protector" to guard against inappropriate action (or inaction) by the trustees. The trust protector should have the power to discharge and appoint independent trustees within the trust protector's discretion.

e. *Advanced Considerations*

i. An APT can be combined with a limited partnership ("LP") or limited liability company ("LLC") to permit investment management and control of the trust assets to continue in settlor without jeopardizing the nature of the transfer as a completed gift.

(1) Structure may provide lack of marketability and lack of control discounts on the transfer of limited partnership or membership interests to the trust, thereby permitting the transfer of real value in excess of the amount subject to taxation.

(2) Structure will provide an additional layer of protection between third-party creditors and the trust.

(3) In the unlikely event of trust creditors, enforcement of a judgment will be limited to a charging order against the trust's limited partnership or limited liability company interest.

(4) Use of an Alaska or Delaware limited partnership or limited liability company will increase the settlor's contacts with that state, further justifying the application of that state's law to the claims of any creditor of the settlor.

ii. An APT can be combined with any split-interest gift in trust (such as a QPRT, GRAT, or CLT) in order that the settlor may continue to have discretionary access to the transferred property after the initial term of the trust has expired.

iii. An APT can be used to own the settlor's life insurance policies in the same manner as an irrevocable life insurance trust. So long as the settlor does not retain incidents of ownership in the transferred policies he or she can be a discretionary beneficiary, thereby permitting distributions of cash value to the settlor. *See* Priv.Ltr.Rul. 94-34-028.

f. *Domestic v. Offshore*

i. *Introduction*

(1) Although highly touted as an asset protection vehicle, domestic trusts are generally inferior to foreign situs asset protection trusts because of legal distinctions between domestic and foreign trust law as well as the practical difficulties encountered in proceeding against a trust (and its underlying assets) situated abroad.

(2) Selected foreign asset protection jurisdictions will not honor judgments rendered by courts in the United States, thereby requiring a creditor to relitigate its claims offshore. In contrast, a U.S. court is required by the Full Faith and Credit Clause of the U.S. Constitution to honor the validly rendered judgments of its sister states (U.S. Constitution, Article IV, Section 1).

(3) The statute of limitations for fraudulent conveyances in selected foreign asset protection jurisdictions may be as short as one year from transfer.

(4) The standard of proof for a creditor on a fraudulent conveyance claim in selected foreign asset protection jurisdictions can be as high as "beyond a reasonable doubt" (a standard normally used exclusively for criminal matters in the United States).

ii. The issue of which is better, domestic or offshore, should therefore focus on a settlor's primary use of the structure as an estate planning vehicle, rather than as an asset protection vehicle.

iii. *Considerations In Favor Of Offshore Trusts*

(1) Statutory framework and case law in foreign jurisdictions may provide greater certainty to the result of a settlor's transfer (such as whether the transfer is a completed gift despite the trustees' discretionary power to return the trust assets to the settlor).

iv. *Considerations In Favor Of Domestic Trusts*

(1) Although a properly structured foreign situs asset protection trust should not be taxed any differently than a domestic trust, substantial reporting requirements are imposed on foreign trusts with U.S. beneficiaries.

(2) Many offshore asset protection trusts are designed with either automatic or discretionary "flee" clauses to cause the trust to "migrate" abroad when creditor problems arise. At that point the trust will be deemed "foreign" under the IRC and may become subject to additional tax reporting requirements.

(3) Prospective settlors of offshore asset protection trusts must concern themselves with the economic stability and political security of the jurisdiction whose laws they are entrusting their assets to compared with the economic stability and political security in the United States.

(A) Even offshore jurisdictions with extensive histories of political and economic stability may probably not provide the same level of comfort as a domestic trust.

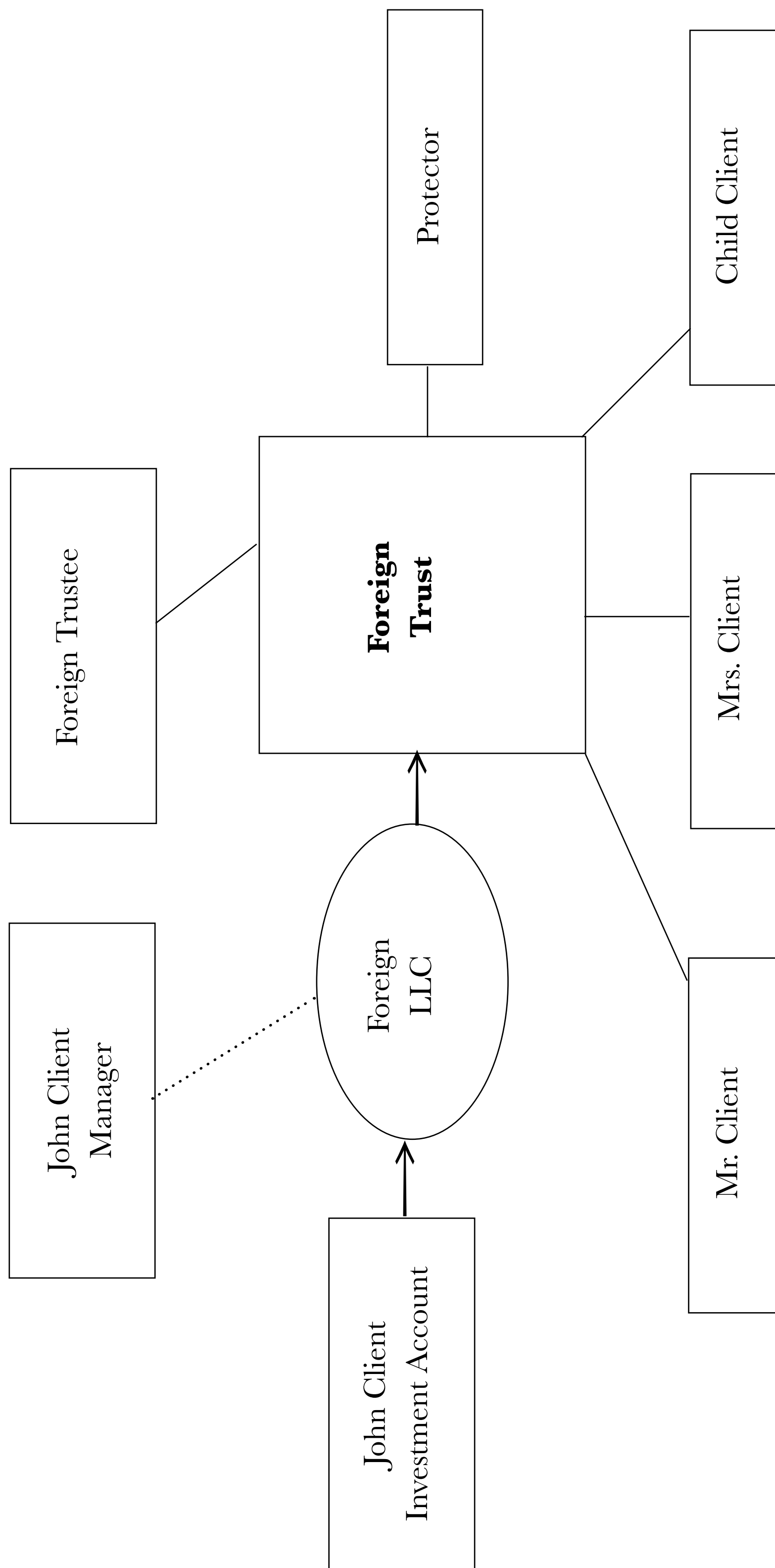
(4) U.S. federal and state courts and the IRS may regard domestic trusts as a more legitimate creditor protection and estate planning device than offshore trusts.

(A) A domestic court may resent transfers outside of the jurisdiction of U.S. courts and reason that no "legitimate" reason exists for using an offshore trust (rather than a domestic trust) other than thwarting the domestic legal system. *See, e.g., In Re Portnoy*, 201 B.R. 685 (S.D.N.Y.Bkrtcy.Ct. 1996) and *B.V. Brooks*, 217 B.R. 98 (D.Conn.Bkrtcy. 1998).

(5) Domestic trusts should, both in their creation and in maintenance, be less expensive than offshore asset protection trusts with comparable assets.

v. *Considerations In Favor of Alaska Or Nevada*

(1) Due to the carve-outs available to certain creditors under Delaware's statute, there is a risk the IRS may take the position that the trust property, being subject to claims of creditors, even though restricted, nonetheless renders the transfer incomplete for gift and estate tax purposes.



EXAMPLE

	Dynasty Trust	Without Trust
Initial Amount (Grantor 50 Years Old)	$ 1,000,000	$ 1,000,000
Value at Grantor's Death	------------------	-------------------
(7 percent Growth – 25 Years)	$ 5,427,432	$ 5,427,432
Estate Tax @ 55 percent	0	(2,985,088)
	$ 5,427,432	$ 2,442,344
Value at Child's Death – 50 Years	$ 29,457,027	$ 13,255,658
Estate Tax @ 55 percent	0	(7,290,612)
	$ 29,457,027	$ 5,965,046
Value at Grandchild's Death – 75 Years	$159,876,030	$ 32,374,885
Estate Tax @ 55 percent	0	(17,806,187)
	$159,876,030	$ 14,568,698
Value after Four Generations – 100 Years	$867,716,164	$ 79,070,627
Estate Tax @ 55 percent	0	(43,488,845)
	$867,716,164	$ 35,581,782

ASSET PROTECTION AUDIT CHECKLIST

I. Determine Possible Sources Of Liability

- A. Professional Malpractice
- B. General Torts (for example, auto accidents)
- C. Contract Claims
- D. Creditor Exposure
- E. Officer And Director Liability
- F. Environmental Liability
- G. Divorce
- H. Forced Heirship (such as right of election)
- I. Political Threats
- J. Economic Risks
- K. Existing Lawsuits

II. Insurance Adequacy Analysis

- A. Homeowners
- B. Auto
- C. Umbrella
- D. Business Risks
- E. Directors and Officers
- F. Disability
- G. Life

III. Maximization Of Exemption Allowances

- A. Does Client Participate In Or Have Retirement Plans?
  - 1. Determine Exempt Status
- B. Is Homestead Exemption Available?
  - 1. Ascertain How Title Is Held
  - 2. Consider Effects (Tax And Nontax) Of Changing Title
- C. Determine Extent Of Joint Ownership Or Community Property

IV. Review Estate Plan And Nature Of Asset Holdings With View Toward Creditor Protection

- A. Does Client Expect Large Inheritance?
  - 1. Ascertain Whether Outright Or In Trust
- B. Do Wills And Trusts Provide For Outright Distributions To Beneficiaries?
  - 1. Consider Amending To Retain Assets In Trust
- C. Business Activities
  - 1. What Form of Entity Is Used?

    ❑ LLC ❑ Corp ❑ Sole Proprietor

    ❑ LLP ❑ LP
  - 2. Is Client A General Partner?
  - 3. Has Client Provided Guarantees?
  - 4. Consider Reorganizing Holdings And Segregating Assets With Liability Potential

V. Prepare Solvency Analysis

VI. Consider And Discuss The Following Techniques To Protect Wealth

- A. Domestic Trusts
  - 1. Non-Self-Settled
    - a. QPRT
    - b. CRT/CLT
    - c. QTIP
    - d. Discretionary
    - e. Power Of Appointment
    - f. Sale To Grantor Trust
  - 2. Self-Settled
- B. Foreign Trusts
- C. Swiss Annuities
- D. Foreign Life Insurance
- E. Limited Liability Entities