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Asset Protection Planning - Basic Track

Offshore Trusts and the Mechanics of Establishing Them

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The Mechanics of Establishing an Offshore Trust*

by Alexander A. Bove, Jr.

There seems to be no shortage of articles and even treatises on offshore asset protection trusts. Just about every facet of the subject seems to have been exhaustively covered, except, perhaps, how to actually set one up. Once an advisor has determined that offshore is the place to go for his client, what comes next? This article offers a practical overview of the steps to be taken from beginning to end in establishing an offshore trust. Of course, it is not possible to anticipate every set of circumstances or every glitch that could arise, but there should be enough here for the “novice” to successfully complete his first offshore venture.

The Decision To Go Offshore

Unfortunately, many advisors and perhaps even a greater number of clients believe that the menu of asset protection planning consists of one item: offshore trusts. This is simply not so, and any advisor who thinks that is way off the mark. There are many other options and combinations of options that may all be carried out domestically.¹ Therefore, the first order of business for the advisor is to ascertain the level of the client’s need for asset protection and, based on this and in light of the extent and nature of the client’s assets and personal and business circumstances, determine just what type of asset protection plan is indicated.

Everyone wants a plan to protect what she has accumulated, but certainly not everyone needs to go offshore to do it. Sometimes, protection is merely a case of securing or increasing a client’s liability insurance coverage, or operating a business in a different form, such as a limited liability company or a corporation. And even for non-business assets, it may be possible to obtain protection of assets through self-settled discretionary domestic trusts in Alaska, Delaware, Nevada, or Rhode Island², or through limited discretion self-settled trusts in any of the other forty six states.

Only after all domestic plans have been considered and it is decided that they do not provide the degree of protection desired or suitable for the particular client should the decision be made to go offshore. And when is that? In most cases, when:

- a) there are substantial liquid assets to be protected (upwards of \$1 million);
- b) there is a strong indication that because of the type of exposure this client has to potential claims, and because the history or trend of that type of claim suggests that judgments or settlements would be considerable (e.g., medical malpractice), a creditor would be inclined to diligently attack any assets held in the U.S.;
- c) the client has been thoroughly advised of the extensive reporting requirements associated with offshore trusts and the penalties for failure to comply with such requirements,³ and
- d) the advisor has concluded, after adequate due diligence, that an offshore trust is the appropriate and best plan for the client.

Due Diligence

There is growing concern over the ethical exposure and personal liability of an advisor who actively assists a client in making a fraudulent conveyance. While the certainty and extent of any such liability is not at all clear, it is generally accepted that an advisor should not knowingly advise or assist a client in making such a conveyance. But how would the advisor know whether the client advised him fully of the client's circumstances, particularly with respect to pending, threatened, or expected claims? The answer is, it is very difficult and sometimes impossible, especially if the client conceals information. Therefore, the advisor should undertake reasonable efforts to determine as much as he can about the client's situation, which should include the requirement that the client produce a current personal financial statement prepared by the client's accountant, an affidavit (from the client) relating to the statement and to all other representations he has made to the advisor, and possibly an electronic search for cases referencing the client as a named defendant.⁴

Even after it is determined that the client has no threatened, pending, or expected claims against her, most advisors recommend that the client transfer no more than one-third to one-half of her total liquid assets to the offshore trust. This is to avoid a subsequent creditor's claim that the client did not retain enough

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funds to pay her anticipated liabilities as they came due, and therefore she made the transfer with the intention of prejudicing such creditors. If there is a claim that has already been made against the client, this does not mean she cannot protect her assets for other purposes. If the amount of the claim is known, the client can retain an amount adequate to cover the claim and transfer to the trust an amount in excess of the claim. Some attorneys who utilize offshore trusts, instead recommend transferring all of the assets that are earmarked for the offshore trust (not all of the client's assets) into the offshore trust but acknowledging the existing claim and providing in the trust that in the event a judgment is ultimately rendered against the client on this claim, the trustee may pay the judgment from trust funds. This author does not use or favor such an arrangement.

Your Place or Mine? Selecting a Jurisdiction

One of the most puzzling and, in some cases, daunting questions facing the uninitiated asset protection advisor is, where to establish the trust? We read and hear about so many jurisdictions, from the exotic, such as Vanuatu, to the legendary, such as (quite undeservedly) the Cayman Islands, and a large number of in-betweens. Selecting a jurisdiction could be a time-consuming task if every time an advisor prepared an offshore trust he was required to research the respective law and compare the key issues of all prospective jurisdictions. In fact, it would really be out of the question. Fortunately, we have the advantage of the research, mistakes made, and experience of the many advisors who have gone before us leaving a valuable, narrowed-down list of the more accepted and widely-used jurisdictions, chosen largely because of their favorable laws and attitude towards asset protection trusts, as well as their stability.

Although most advisors use common law jurisdictions because of the recognition of trust law and similarity of the legal system, some favor a civil law jurisdiction, such as Liechtenstein. Liechtenstein has adopted trust law by statute (1926) and is internationally respected for the protection given its family foundation (Stiftung). It often follows that creditors who find they must initiate their action in the jurisdiction and conduct all proceedings in German, are discouraged from pursuing the claim.

The select jurisdiction list is generally arrived at by considering and comparing the important criteria of each jurisdiction as applied to the operation and survival of the asset protection trust. For instance, after considering the easy items, like location, language, communications, government stability, common vs. civil law, and time difference, one must consider the more serious questions, such as whether foreign

judgments are recognized and the period of limitations for fraudulent conveyances. In the more favorable (and therefore most popular) jurisdictions, such as the Cook Islands, the Bahamas, and Gibraltar, the courts will not recognize a US judgment, and the period of limitations for fraudulent conveyance purposes is two years, or less. For instance, under Gibraltar law, if the transfer to the trust did not render the settlor insolvent (the burden of proof being on the attacker in an action brought in that jurisdiction), then there is no waiting period – the protection of those trust assets is immediate.⁵ And in the Cook Islands, a creditor attacking the trust must prove beyond a reasonable doubt that the settlor intended to defraud that particular creditor in order to reach trust assets.⁶

It should be noted that even in those jurisdictions which are not necessarily at the top of the veteran asset protection advisor's list, e.g., Isle of Man, Jersey, or Bermuda, there is a certain amount of inherent asset protection value due to the fact that the assets are not in the U.S., and a creditor is forced to undertake legal proceedings in the jurisdiction governing the administration of the trust. This can be expensive and time-consuming, and often unproductive, especially if the situs of the trust is changed⁷ before the creditor can engage local counsel and be heard by the local court.

In sum, unless you have selected a particular jurisdiction through your own research, it is probably best to consider as possible candidates those jurisdictions which are generally accepted as the two or three “first choices” by the experienced asset protection bar. Which of those few you select may depend on the client's particular circumstances, confidence in a particular trustee desire to travel to that location, or general comfort level.

The Trustee

Once we know where the trust is to be sited, it should be an easy matter locating a trustee to act for the trust. It should be, but it isn't. If you choose the Cook Islands, for example, how do you know where to begin? Make a few calls? If you do you'll have to do it between the hours of ? and ?, because they are ? hours behind us. And if you choose the Bahamas because they are so much closer and the time zone is more convenient, it is important you may want to interview a few trustees before you choose. For one thing, you'll find the fee schedules for trustees there can be quite different from one to another. Furthermore, you will find that some trustees have a policy of refusing to sign or file any documents with the US government (i.e., The IRS). This poses a serious problem because of the US requirement that the

trustee of a foreign trust provide information for and sign form 3520 A (Annual Return of Foreign Trust with US Beneficiaries) each year.⁸ Failure of the trustee to comply will cause a penalty to be imposed on the settlor of the trust.⁹

In general, corporate trustees in any of the common offshore jurisdictions charge origination and set-up fees ranging from \$3,500 to \$6,000, and annual fees around the same, but this usually does not include the fees for managing the trust funds or the fees for the “protector” (discussed in the following section). Management fees are usually additional and depend on the amount being managed. It is not unusual to have a money manager and a trustee, unlike the typical US case, and in fact, it is fairly common to have a trustee in one jurisdiction and the funds managed by a money manager in another jurisdiction.

You should also be sure that arrangements are clear as to when and to whom investment reports and trustee’s accounts are to be sent out. The client should receive quarterly reports of the investment and trustee activities without fail. It can be very upsetting, to say the least, to a client when she fails to get information on the status of her funds situated four thousand or more miles away (including confirmation that they are still there!). When this does not happen, it is easy to conjure up an image of the offshore banker dressed in shorts and dockside sailing off in a schooner with the client’s money neatly stacked beside him.

One way to find candidates for trustee is to ask other advisors who have used trustees in the particular jurisdiction; this is usually the best referral source, since they would hardly recommend any with whom they had a bad experience. Another way is to use a professional publication that advertises and/or lists trustees and fiduciaries in the several offshore jurisdictions. One such publication is “The OFC Report.”¹⁰ This is published on an annual basis, and in addition to articles of interest on the various “offshore financial centers”, it contains a list of professionals, including trustees, in all of the listed jurisdictions with full contact information. If you locate a trustee in this way you should ask that they give you professional references (e.g., U.S. attorneys) that you may call.

The Protector

Most offshore trusts provide for the appointment of a protector. This is an individual (or a company) that acts “outside” the trust but who can have authority ranging from veto powers over proposed trust

distributions, to removal and replacement of trustees, to additions or deletions of beneficiaries, and more. A newcomer to the field would be wise to not to get carried away with giving extensive powers to the protector, since, in some cases, depending on the selection of protector, there can be unanticipated tax ramifications.¹¹

A good understanding of the protector's role and a careful selection of the protector can be critical to the successful operation of the trust. In many cases, the client herself may want to be the protector since acting in that position gives her extensive control over the trust. It also gives a US court the opportunity to order the client/protector to remove the offshore trustee and appoint a US trustee which would bring the trust under the jurisdiction of a US court. Failure to comply with such an order could subject the client to a contempt of court charge and possibly jail until the order is carried out. Many offshore planners, including this author, believe it is a good general rule to avoid naming any US protector. It is not unusual to name an attorney or accountant in the foreign jurisdiction. Although the fees, of course, will vary with the extent of the services required, a typical fee is \$1,500 annually.

The Documents

So, we have a client, we have a need for an offshore protective trust, we have a jurisdiction, and a trustee. Now all we need is a trust. Drafting an asset protection trust is not something you can do without some tutoring or, more typically, a model to work from. Although most common law trusts have numerous "standard" provisions, the offshore asset protection trust has many provisions that are quite uncommon to the typical trust and therefore would likely be omitted by the inexperienced draftsman of offshore trusts.

For instance, offshore trusts typically contain a "flee clause", allowing the trustee, in the event of an anticipated attack on the trust, to change the trust situs and its governing law before the attack occurs. Also, such trusts usually have an "anti-duress" provision, which permits the trustee to totally ignore an otherwise legal request for a distribution if the trustee believes that the request was made under some form of duress (such as a court order to repatriate the funds). And since appointment of a protector is typically provided for in the trust, the trust will have extensive provisions covering the protector's powers and the trustee's responsibilities in dealing with the protector. Also important are the provisions relating to removal of the protector (if desired) and appointment of a successor protector.

Remember, the offshore asset protection trust is an irrevocable, self-settled spendthrift trust. The client should retain no powers that a court might order her to carry out and which could in any way favor a US creditor of the client, such as a power to remove and replace a trustee or a protector. Nevertheless, flexibility can be built in through a combination of powers residing in the trustee and the protector, and not the client. Many of the offshore trustees will provide a form of the trust document that is acceptable to them, and although this may be a good place to start it is certainly not a good place to finish. Furthermore, be aware that, unlike US trust companies, many offshore trust companies actually charge a fee, usually in the vicinity of \$1,500, to provide a sample trust. There are also form books you may use, which are very helpful.¹²

Typically, the offshore trust will hold a substantial part of the U.S. settlor's assets, and even though offshore protective trusts are generally tax neutral from an income tax standpoint, they are not from an estate tax standpoint, so it is very important that the trust include the appropriate US estate tax provisions necessary to carry out the client's estate plan.¹³ Such provisions are generally not included in the model forms provided by the offshore trusts.

Note also that the trust is not the only document that will be required by the offshore trustee. Before the trustee will accept the trust, it will also require a personal financial statement for the client, certified to be true and up to date by the client, the client's accountant, attorney, or other professional, a character reference from the attorney or from a bank including a statement as to the source of the client's funds, and an affidavit of solvency and claims status from the client. (See a sample affidavit at the end of this article). If the client advises the trustee of particular claims pending or brought against her, the trustee may want the trust to provide an exception for the claims (allowing them to be paid from the trust) or may require assurances and verification that the client has retained assets outside the trust adequate to cover the particular claims.

Putting the Show on the Road

Now we should be ready to put our money where our trust is. In the usual case, some "seed" money, say \$5,000, will be sent (often wired) to the offshore trustee to open the trust account. Shortly thereafter, the balance of funds and/or securities will follow. As noted earlier, discussions with and selection of the trustee would normally include arrangements for management of the funds or the portfolio either by the

trustee or by a money manager separate from the trustee. Occasionally, clients wish to continue to manage their own funds, and this can be done through various means, but in serious asset protection plans it should not be done by leaving the funds with a US broker. This is not impossible, as explained below, but it does leave the funds vulnerable to a court order. Nevertheless, it is appropriate to note here that some asset protection plans are designed so that the funds and the portfolio in fact remain in the US to be managed by the client until trouble strikes, at which time they are (hopefully) whisked away to the safe offshore jurisdiction before the creditor can gain access. Here is how that arrangement usually works:

The client will establish a domestic limited partnership where the client, and perhaps her spouse, are 1 or 2 percent general partners and the client a 98 or 99 percent limited partner. The assets to be protected are transferred to the partnership, and client then transfers her 98 or 99 percent limited partnership interest to her offshore asset protection trust. Since the assets are situated here in the U.S. partnership, and since the client is a general partner, she has full management control of the assets. As soon as the suit hits the fan, however, the partnership is liquidated, the assets reduced to cash (unless there is time to transfer the securities in kind), and the cash is distributed to each of the partners in proportion to their respective interests. Since the offshore trust is a 98 or 99 percent partner, virtually all the funds are paid over to that trust, offshore, and far outside the creditor's immediate reach. If the limited partnership interest has been held by the offshore trust long enough (typically four years in the US, though it is not entirely clear in this situation whether the US or the offshore period of limitations would apply), there should not be a fraudulent transfer issue.

Advise Client of Filing Requirements

One of the unique features of our US tax system when compared with the rest of the world is the tracking of income (and almost everything else) through a person's social security number. Banks, brokers, and other financial parties will not deal with any US person without a "tax ID" number. This enables those parties to report to the IRS all income and capital transactions relating to the person with that tax number, and the IRS, in turn, can track the reporting; so if a person fails to report bank interest, for example, he'll certainly hear from the IRS about it.

The rest of the world, however, works a little differently. There is no such thing as a social security number, and in just about all of the jurisdictions where an offshore trust may be established, there is little

or no tax. Therefore, to the offshore jurisdiction it is of no consequence that the trust account generates income or gains, and until January 1, 2001, such jurisdictions reported nothing to the IRS.¹⁴ Because of this situation, the IRS believed that huge amounts of offshore income, particularly in trust accounts, went unreported by US persons who were settlors of such trusts, despite the fact that they were fully subject to tax on the income.¹⁵ On the basis of this information, Congress passed laws in 1996 (as part of The Small Business Jobs Protection Act, Pub. L. 104-188) and 1997 (as part of the Taxpayer Relief Act, Pub. L. 105-34) requiring a US person who makes a transfer to a foreign trust and/or who received any distributions from a foreign trust, to report such transactions to the IRS.¹⁶ Failure to report as required subjects the US person to substantial penalties (for instance, 35 percent of the amount transferred or distributed¹⁷).

Accordingly, an advisor would be remiss and perhaps even exposed to liability if he prepared and helped establish an offshore trust for a client but failed to advise the client of her obligations to report to the federal government on account of the trust, and the need to appoint a US agent for the trust.¹⁸ As a matter of course, then, advisors who establish these trusts should advise the client in writing of the filing requirements and forms to be filed (see a sample letter at the end of this article). For more information on reporting requirements, advisors may wish to refer to IRS notice 97-34, and the instructions to IRS Forms 3520, 3520 A, and TD F 90-22.1.

Summary

Establishing an offshore trust for a client involves some new areas of law and unique considerations, especially in the provisions that are customarily included in such trusts. Nevertheless, an experienced estate-planning advisor should be able to adapt and competently handle such a project, after some research on the more unique issues, such as jurisdiction, after study of the legal and tax forms involved, and after consultation with other professionals in the field. Further, as in all complex tax matters, it is essential to thoroughly advise the client of his ongoing responsibilities with respect to the project.

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¹ See, “*What Attorneys and Advisors Should Know About Asset Protection Planning*”, by Alexander A. Bove, Jr., *Asset Protection Journal*, Vol. 2 No. 4, Winter 2001

² *Id.*

³ See generally Internal Revenue Code (IRC) section 6048 and IRS notice 97-34

⁴ The idea was proposed by Gideon Rothschild, a highly reputed attorney in the fields of estate and asset protection planning and a partner with the New York City law firm of Moses & Singer, LLP.

⁵ Bankruptcy Ordinance of Gibraltar, Section 42

⁶ A number of very helpful articles have been written on selection of a jurisdiction. See e.g., “*Asset Protection and Jurisdiction Selection*”, by Duncan E. Osborne, 33rd Heckerling Institute on Estate Planning

⁷ Most asset protection trusts have a “flee” or flight” clause authorizing the trustee to move the trust (and assets, if applicable) to another jurisdiction, so that it would no longer be governed by the laws of the first jurisdiction.

⁸ IRC sections 6048 (b), and IRS Notice 97-34

⁹ IRC section 6677 (b)

¹⁰ The OFC report, published by Campden Publishing Ltd; 40-44 Clipstone Street, London W1P 8LX, UK. Tel + 44-171-636-1600, Fax 636-1745; email campden@campden.com, internet www.campden.com. Professionals should request a complimentary copy.

¹¹ See, “*Coordinating an Asset Protection Plan with An Estate Plan*”, by Alexander A. Bove, Jr. and Marjorie Suisman, *Asset Protection Journal*, Vol. 1 No. 3, Autumn 1999.

¹² See, e.g., “*Asset Protection: Legal Planning, Strategies and Forms*”, Peter Spero, Warren Gorham & Lamont

¹³ *Id.*

¹⁴ Beginning January 1, 2001 most jurisdictions will report to the IRS information on accounts it is holding for US persons if and to the extent those accounts hold any US securities. See Treasury Decision 8881 (65 Federal Register 32152).

¹⁵ IRC section 679

¹⁶ IRC section 6048. Note also the 5 percent penalty imposed on the grantor if the foreign trustee fails to file the trust information return, IRC section 6677 (a)

¹⁷ IRC section 6677 (a)

¹⁸ IRC section 6048 (b) (2). For a sample agent’s agreement, see IRS Notice 97-34. See also instructions to Form 3520, page 3. The primary function of the agent is to respond to any IRS requests for records or information relating to the trust or its tax treatment, or to receive notices and service of process by the IRS. It does not subject the trust to US courts or to a creditor’s service of process against the trust.

4. I do not contemplate filing for relief under any of the provisions of the U.S. Bankruptcy Code, nor am I involved in any situation that I reasonably anticipate would cause me to file for relief under any of the provisions of the U.S. Bankruptcy Code in the future.

5. I have read and understand the description of the Money Laundering Control Act, a copy of which has been made available to me, and I confirm and represent that none of the assets which I may transfer as contemplated in this affidavit has been derived from any of the activities specified in such Act.

Witness my and seal this ____ day of _____, 2005,

Andrea A. Client

STATE OF _____

County of _____

This Affidavit [any schedules which are added should be signed, dated, and notarized accordingly] was SUBSCRIBED AND SWORN to by the said [Andrea A. Client] who is personally known to me, as her free act and deed before me, a Notary Public in and for the STATE OF _____ this ____ day of _____, 2005.

Witness my hand and official seal,

Notary Public
My Commission Expires : _____

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