

SPECIAL DRAFTING CONSIDERATIONS FOR ASSET PROTECTION TRUSTS

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I. INTRODUCTION. As with any sophisticated estate planning structure, a foreign situs asset protection trust requires custom drafting. In addition to the anticipated client driven matters, the drafting process is further complicated by the multijurisdictional nature of the structure. The challenge for the practitioner is to create a comprehensive structure that takes into account the jurisdictional as well as the client specific variables. The often used “one size fits all” document (especially one provided by the foreign trustee) is particularly misplaced in this context.

When drafting the trust document (indeed when planning each piece of the structure) it is helpful to envision the trust as a spectrum with minimal asset protection at one end and maximum asset protection at the other end. Each decision that is made in planning for and drafting the trust provisions represents a point along that spectrum, with the end result being an average of all of the points.

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II. GENERAL DESIGN ISSUES. Before analyzing the specific trust provisions there are several design issues that require resolution.

A. Pourback vs. Wholly Dispositive Trust. The trust's design can be either one in which the trust's assets are "poured back" into the settlor's probate estate or revocable management trust or one in which the trust assets remain in further trusts after the settlor's death, similar to those created at death by the settlor's will or revocable management trust. The "pourback" trust is much simpler to draft given its single purpose nature but from an asset protection standpoint it is arguable that it is not as supportable under strict scrutiny given its obvious single purpose.

B. Joint vs. Sole Settlor Trust. Depending upon the situation, the trust may be either a joint settlor trust or a sole settlor trust. If it is a joint settlor trust the document should contain provisions necessary to divide the trust assets between the surviving spouse and the deceased spouse and to distribute the share attributable to the deceased spouse to the deceased spouse's designated beneficiaries or trusts for their benefit. A sole settlor trust must only contain provisions pouring the trust assets back into the settlor's probate estate or revocable management trust or into further trust(s) for the benefit of the settlor's designated beneficiaries.

C. Trustee and Protector. Although it is certainly possible for a foreign situs asset protection structure to not incorporate a protector into the trust's design, the plan will be much more flexible and more protective for the beneficiaries if a protector is employed in the plan. If the protector is included in the plan then the trust document should delineate what trustee actions require protector approval, how protector succession will be handled, etc. Once drafted, the protector should be given an opportunity to review the trust document and make suggested changes if necessary to make him comfortable serving as protector. In order to achieve continuity, a corporate protector is generally advisable. The protector should also be a foreign individual or company if maximum asset protection is desired by the client.

D. Separate vs. Community Property. Before drafting, it is important to understand whether the assets that will be settled in the trust will be separate or community. For this purpose, you must look to the laws of the settlor's domicile. If the assets will be community property then the rights of both spouses in the property must be protected in order to avoid perpetuating a fraud on the community or otherwise thwarting the right of the spouse.

E. Domestic vs. Foreign for Tax Purposes. Prior to the enactment of the Small Business Job Protection Act of 1996 (the "1996 Act") the Internal Revenue Code did not specifically define what constituted a foreign trust and what constituted a domestic trust. The 1996 Act attempted to clarify this issue by revising I.R.C. §7701(a)(30)(E) to say that a trust is a domestic trust if: (1) a court within the United States is able to exercise primary supervision over the administration of the trust; and (2) one or more United States persons have the authority to control all substantial decisions of the trust. All other trusts are foreign trusts. I.R.C. §7701(a)(31)(B). (See Exhibit A for a copy of the statute and regulations.) Although asset protection concerns often dictate that the trust be foreign for tax purposes, it is possible to create a domestic trust for tax purposes which also exhibits many asset protective features.

1. Hybrid Trust. In planning for the foreign situs asset protection structure, it is possible to create a "hybrid" trust that is governed by foreign law but is domestic for U.S. tax purposes. If the client is adverse to the tax reporting that is attendant to a foreign trust for instance, the hybrid structure would allow the structure to import the foreign law while avoiding the more time intensive tax reporting. In order to fulfill the necessary requirements for classification as a domestic trust, it must meet both the "court test" and the "control test." Because the structure must meet both the "court test" and the "control test" for the trust to be classified as domestic for U.S. tax purposes, it is important to analyze these provisions separately.

- [a] Court Test. The court test is satisfied if a U.S. court can exercise primary supervision over the administration of the trust. Under the safe harbor provision contained in Treas. Reg. §301.7701-7(c)(1) a trust will satisfy the court test if: (i) the trust instrument does not direct that the trust be administered outside of the U.S., (ii) the trust is in fact administered exclusively in the U.S. even though the trust document doesn't direct that it be administered in the U.S., and (iii) the trust is not subject to an automatic migration provision (which highlights the importance of not using a "cookie cutter" form because the automatic inclusion of a "flee clause" would cause the trust to fail the court test).

***Automatic flee clause** is a provision in a trust document that says that if a U.S. court attempts to obtain jurisdiction over the trust that the trust will automatically migrate to another jurisdiction. Often these clauses will not specifically reference U.S. courts but if the trust is attempting to satisfy the court test, the reference to "any court" that is usually included in these clauses will have the effect of thwarting a U.S. court's supervision of the trust, thereby causing the trust to fail the court test.*

- [b] Control Test. The control test is satisfied if one or more U.S. persons (who are fiduciaries, protectors, beneficiaries, settlors, or any other persons) control all substantial decisions by majority vote or otherwise, with no non-U.S. person having veto authority over any substantial decision. I.R.C. §7701(a)(30)(E)(ii) and Treas. Reg. §301.7701-7(d)(1)(iii). "Substantial decisions" are those decisions which are required to be made under the terms of the trust document and applicable law and which are not ministerial. Treas. Reg. §301.7701-7(d)(1)(ii). The regulations list examples of substantial decisions such as decisions regarding distributions, selection of a beneficiary, how to allocate receipts between income and principal, whether to terminate the trust or replace trustees, etc. Treas. Reg. §301.7701-7(d)(1)(ii).

[c] Drafting Issues. Therefore, given the specific language in the Regulations, in drafting a hybrid trust, it is very important to assure that the U.S. trustees control the substantial decisions of the trust (tying this definition to the statute and the regulations is an efficient way to handle this issue). To that end, it is also very important to provide that the protector also be a U.S. person because the protector will typically be given the ability to veto trustee actions characterized as "substantial decisions" by the statute and regulations. For that reason, it is important to also have a U.S. person serving as protector in a hybrid structure. (See Exhibit B for examples of provisions which assist in shoring up the domestic characterization of a hybrid trust.)

2. Hybrid Trust in a Foreign Situs Asset Protection Structure. If the goal of the structure is protection of the assets from a U.S. legal system that is creditor-friendly, then a structure which abdicates control to U.S. persons seriously undermines the ability of the structure to insulate the assets from attack. That being said, however, if instead of hardwiring control in the U.S. persons the trust document instead allows for the possibility that the U.S. trustee(s) and protector(s) will resign, making the trust a foreign trust in the case of a future problem, or if the assets in the trust are statutorily exempted in any event like life insurance, then the hybrid trust may be an acceptable intermediate planning step.

F. Grantor Trust Classification. If the settlor is a U.S. person and the trust is classified as a foreign trust under I.R.C. §7701(a), the trust will be a grantor trust for U.S. income tax purposes. I.R.C. §679. There is no need to add additional controls such as those contained in I.R.C. §§672 - 678 to cause the trust to be taxed as a grantor trust. (See the article entitled "Demystifying Taxation of the Foreign Trust - The Workings of Internal Revenue Code Sections 679 and 684" attached as Exhibit C for a more exhaustive discussion of this issue.) If the trust is a hybrid trust (as discussed

above in Paragraph E.) and the settlor remains a beneficiary of the trust, then the trust will also be a grantor trust but under the provisions of one or more of I.R.C. §§672 – 678, depending on the structure of the trust and the provisions contained in the trust document.

G. Transfer and I.R.C. §684 Tax Issues. A foreign situs asset protection trust can be structured as either an incomplete or complete gift for U.S. federal transfer tax purposes. However, it is more likely that given the trust's purpose the settlor of such a trust will settle assets with a far greater value than the gift tax exempt amount into the trust. Therefore, in order to avoid making such a taxable transfer and thereby creating a corresponding tax liability, the vast majority of these trusts are intended to be incomplete gifts. With that being said, the most prevalent error made is the absence of provisions giving the settlor the control necessary to cause the gift to the trust to be incomplete. (See Treasury Reg. §25.2511-2.) Many of these documents are the product of lawyers who either farm out the drafting of these documents to the foreign trust companies or their attorneys or who use a form provided by such companies or attorneys. On occasion the documents are drafted by income tax or business attorneys who are not sensitive to this issue. For that reason it is very important for an attorney who is well versed in the transfer tax issues to be involved in drafting these trusts.

Transfers to foreign situs asset protection trusts created by U.S. settlors will not be subject to the I.R.C. §684 capital gains tax because the trust will be a grantor trust pursuant to I.R.C. §679 and therefore transfers to such a trust are exempt from this tax. If the gift to the trust is also incomplete for gift tax purposes then the assets will be included in the settlor's estate for federal estate tax purposes and such assets will not be subject to the I.R.C. §684 tax at the settlor's death because the basis in these assets will be "stepped up" to fair market value for purposes of determining the recipient's basis under I.R.C. §1014(a). Conversely, if the gift to the trust is complete for federal estate tax purposes, the basis in these assets will not be "stepped up" to fair market value at the death of the settlor and therefore the I.R.C. §684 capital gains tax will apply at the

death of the settlor. Because of the different tax results depending on whether the gift is complete or not, it is very important to draft these provisions properly.

H. Review of Trust Document by Foreign Professionals. Given the multijurisdictional nature of the trust document, it is very important for the document to be thoroughly reviewed by an attorney who specializes in trust law in the jurisdiction in which the trust will be situated. The legal issues in the situs must be dealt with appropriately and although written in English, English words and phrases have very different meanings in different countries. (For example, a statement that a trustee may borrow money from itself “without accounting for the profit” means “without disclosing the profit in an accounting” in some jurisdictions and “without remitting the profit back to the trust” in other jurisdictions.) A comprehensive jurisdictional treatise, such as Osborne and Schurig’s, Asset Protection: Domestic and International Law and Tactics (four volumes, West Group, updated quarterly, 1995) which contains a comprehensive jurisdictional legal analysis is extremely helpful in this regard but must serve only as the basis for the jurisdictional analysis. The final review will require the experienced eye of local counsel. That being said, the U.S. practitioner must not accept suggested revisions which alter the tax provisions that are necessary from a U.S. tax standpoint.

I. All Inclusive Trust Structure or Partially by Attachments? As discussed previously, there are various approaches to drafting foreign situs asset protection trusts but it is possible to classify those approaches into two distinct categories. The first one is one in which a standard, “one size fits all” form is used in conjunction with a set of attachments that provide the client specific information (See Exhibit D for examples of these types of attachments.) The benefit of this approach is its cost effectiveness and simplicity. Because the trust document itself is standardized the only thing that the draftsman must do is fill in the attachments, making the whole drafting process simply an information gathering exercise. The downside of this approach is also however, its simplicity because it does not allow for customization through original drafting. In addition, this approach lends itself to error because the individual using the form will often neglect to fully consider the provisions in the

standard form document. The opposite approach is one in which the trust document is inclusive of all necessary information. The benefit of this approach is that it is a more customized approach that should result in a more specific and appropriate document for the client. The downside is that it is more time intensive and therefore more expensive.

III. SPECIFIC DRAFTING ISSUES. Because of the time constraints of our panel, we have been required to choose components of the foreign situs asset protection trust that we feel are most important to discuss in this context. The issues covered in this paper and that of my other panel member are unfortunately not exhaustive.

A. Trustee Provisions. Although similar in many respects to domestic fiduciary provisions, a foreign situs asset protection trust's fiduciary provisions must balance the need for fiduciary flexibility in order to allow for optimum protection of the assets with the need to both protect the beneficiary from the trustee and provide for recourse in the hands of the beneficiaries in the event of trustee misconduct.

1. Provisions Which Provide for Trustee Flexibility. In addition to the typically used, flexible, fiduciary administrative provisions which give the trustee wide latitude in investing trust assets, the following are provisions which are especially helpful in the asset protection context.

- [a] Ability to add and remove beneficiaries
- [b] Ability to amend the trust document
- [c] Ability to change the name of the trust
- [d] Ability to exercise complete discretion in making distributions to beneficiaries
- [e] Ability to distribute assets to other trusts for the benefit of the beneficiaries
- [f] Ability to create new trusts and transfer assets to those trusts (if the document provides for a marital trust this power should either be limited in relation to that trust or the savings clause should be

sufficiently broad in order to prevent this power from causing the marital trust to fail to qualify as such)

- [g] Ability to freely contract with professionals and service providers and to delegate authority to such professionals and service providers
- [h] Ability to pay taxes and governmental charges otherwise owed by beneficiaries whether or not such taxes and governmental charges are legally enforceable against the trustee
- [i] Ability to not disclose information about the trust without direction from the protector
- [j] Ability to appoint trustees in documents other than the trust instrument
- [k] Ability to make affirmative decisions about the place of administration and situs of the trust
- [l] Ability to change the governing law and situs of the trust

2. Provisions Which Provide for Beneficiary Security. Because of the flexibility needed to support a trust designed to achieve maximum protection for its assets, many of the commonly used protective provisions are not appropriate in this context. However, the following are provisions that provide security to the beneficiaries without infringing unduly on the flexibility needed by the trustee in order to be effective in its role of fiduciary of an asset protection trust.

- [a] Protector's ability to remove and replace trustee
- [b] A deed of removal which is effective at the time specified in the deed without the requirement of a waiting period
- [c] Once a trustee is removed, title to the trust assets vests immediately in the hands of the new trustee with no waiting period (this allows for quick removal of trust assets from the hands of a troublesome trustee)
- [d] Deemed resignation of a trustee upon the occurrence of certain events (See Exhibit E for an example of such a clause)

- [e] Requirement that the protector consent to distributions, addition and deletion of beneficiaries, etc.

IV. REDOMICILIATION PROVISIONS. Of utmost importance to a foreign situs asset protection structure is the ability of the trustee and/or the protector to easily redomicile the trust. Rather than giving this power to either the trustee or the protector, it is important to give this power to each of them and to give them the authority to act independently of each other so that if either is subject to a governmental, judicial, or societal issue in their domicile the other will be able to quickly move the trust to a more hospitable environment.

V. PERPETUITY PROVISIONS. Jurisdictions which court foreign situs asset protection trust business will typically either be a civil law country like Liechtenstein which never entertained the perpetuity period concept, a common law country which has abolished the common law Rule Against Perpetuities, or a common law country which has significantly extended the perpetuity period or at least enumerated the period in an easily ascertainable term of years. (See Exhibit F for a list of eight of the commonly utilized asset protection jurisdictions and their perpetuities provisions.) For that reason it is very important to consider these disparate jurisdictional approaches to the perpetuities issue and choose one that is appropriate to each specific client situation. For instance, if the client desires protection only during his lifetime with a pourover of the trust assets to the personal representative of his probate estate or the trustee of his revocable management trust, then a shorter perpetuity period will not be detrimental to the structure. If, on the other hand, the client wants to create a dynastic structure for his family that will remain in trust for as long as possible, then a jurisdiction without a perpetuities period will be the most likely choice for that client.

Unless the client wants to forego any option of transferring trust assets to a country with a common law based legal system, when drafting a foreign situs asset protection trust that will, in all likelihood, move among jurisdictions during its life, it is also important to specifically state that in the case of a redomiciliation, merger, or transfer of assets, that

any such redomiciliation, merger, or transfer will not infringe upon the Rule Against Perpetuities that is applicable to the preexistent trust.

Rule Against Perpetuities. *If the trust is ever situated in a country that has a common law based Rule Against Perpetuities and if the trust provisions do not appropriately meet the requirements of this rule then the trust will fail ab initio, making the trust assets immediately available to the creditor of a beneficiary.*

Furthermore, in order to encourage and facilitate the consolidation of assets in other trusts into the foreign situs asset protection trust it is helpful to delineate a procedure in the document by which such trust assets can be accepted and then segregated in order to protect against a violation of the transferring trust's Rule Against Perpetuities. (See Exhibit G for a sample of such a provision and corresponding definition.)

VI. CONCLUSION. Conceiving and drafting a foreign situs asset protection trust is a multilayered task which requires knowledge of the client's existing and future estate planning goals and documents, the jurisdictional issues that will impact the client and either thwart or facilitate these goals, and the various tax issues involved in the client's unique situation. It is a task that is not for the faint of heart but one which can be rewarding for both the client and draftsman if done correctly.