Proper Utilization Of International Structures For Asset Protection And Integrated Estate Planning

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Abstract

International Asset Protection Trusts, commonly known as "Offshore" Trusts are just one of the international structures that have enjoyed great popularity of late as a means for protection of assets from claims of dubious creditors, and frivolous lawsuits. While they certainly accomplish this goal, there is a lot of misinformation regarding these and other international structures. Care needs to be given as to how any international structure is set up together with an awareness of the pitfalls in the incorrect, or inappropriate formation, timing, or purposes to be achieved using these tools.

A trust is only one of the structures available in the international arena. Most people are familiar with trusts as a means of doing their estate planning. Our legal heritage is derived from England, and is referred to as "common law". In addition to the United States, Canada, Australia, and even India follow it. The same is true for all of those small countries around the world, which once were part of what was known as the British Empire, and are now known as The British Commonwealth. The one thing all of these countries have in common, in addition to their language, is that they all follow the common law to some extent. Trusts are unique to English law.

The person who sets up the trust is known variously as the "Settlor", "Grantor," "Trustmaker", or "Trustor". The person responsible for managing the trust is known as the "Trustee." The people for whom the trust is created and who benefit from it are known as "Beneficiaries." In effect, the trust divides the title to property. The trustee has the legal title to the property, and the beneficiary has a possessory, or right to the use of the property during the term of the trust.

Most commonly, a grantor sets up a trust with some other person as trustee to manage the assets transferred to the trust for the benefit of some third person, either children, grandchildren, or some charity. These trusts are usually irrevocable and often are established by the person's will and are known as "testamentary trusts". They can also be set up by a separate trust instrument and take effect immediately; these are known as "inter vivos" trusts. Sometimes the grantor and beneficiary might be the same person, in which case the trust is considered to be a "grantor" trust.

Grantor trusts do not protect assets transferred to them from future creditors of the grantor, and they are still part of the grantor's taxable estate when he/she dies. The income these assets earn are taxable to the grantor's gross income. Revocable living trusts would be an example of a grantor trust. As an estate-planning tool, a living trust is an excellent method for estate planning. As a tool to protect your assets from future, unknown creditors, it is not.

Trusts can be created in any state in the United States. The trust instrument, variously known as "trust instrument", "trust deed", "trust agreement" can provide that the trust can utilize any trustee, located anywhere, and can select the law that governs the interpretation of the trust, itself. An offshore trust, is merely a trust that provides that the trust utilizes a trustee in a country other than the U.S., and that is governed by another country's laws.

A U.S. trust might name a bank in New York as the trustee and that bank would have the trust accounts located there. An offshore trust will name a bank or trust company in a foreign jurisdiction and have the assets either at that bank, or at another institution titled in the name of the offshore trust. For the best asset protection, it is recommended that domestic accounts not remain in the U.S. since it is the physical presence of an asset that allows a court to assert control over the asset. This concept of control is known in the law as “jurisdiction.”

Alaska and Delaware, in an attempt to cash in on the asset protection trust business have enacted legislation with creditor protection for trusts hoping to become viable alternatives to foreign jurisdictions for asset protection. The laws of these states do not provide absolute protection from creditor attacks, and there are questions yet to be resolved about the constitutionality of these statutes. Finally, the very fact that Alaska and Delaware are part of the United States may also be their undoing in the asset protection arena due to something known as the “Full Faith and Credit” doctrine in the U.S. Constitution, which is applicable to all states.1 This simply means each state must recognize the judgments of other states and the federal government.

Care must always be exercised to avoid the appearance of, or use of offshore structures for a fraudulent purpose. From a pure asset protection standpoint, offshore trusts tend to discourage frivolous lawsuits by making it difficult or inconvenient for overzealous plaintiffs and their lawyers to collect their judgments. The knowledge that you have some international structure in place might actually discourage a frivolous suit against you in the first place.

Transfer of assets to an offshore trust at a time when you are under a cloud of some sort may initially frustrate a creditor: unfortunately, it can subject you to further civil liability and possibly even imprisonment. A fraudulent transfer is a fraudulent transfer whether it occurs in Pennsylvania, or the Bahamas. A fraudulent transfer action brought within the appropriate statute of limitations period and containing the necessary allegations of fraud will quite well subject the trust to a court in the offshore jurisdiction entering an order “freezing” the administration of the trust and the assets within it so that the beneficiaries cannot get their beneficial interest in the trust. This is just as restrictive and oppressive as if the trust were located in Michigan or California and a judge there “froze” the assets in the trust: except that a court in the foreign country now has jurisdiction over the assets and over the trustee, something you will definitely not want. From your standpoint, it doesn’t make any difference whether a U.S. Court, or an offshore court does this, the effect is the same -- non-control of and non-access to assets.

You must be aware that astute plaintiff’s attorneys will always raise “fraudulent transfer” as a way to attack the trust, since that is really the only argument the attorney can hope to make which will have any possibility of success of collecting any of the judgment, whether the transfer was fraudulent, in fact, or not.

In a recent case, the people who set up an offshore trust were put in jail because a court ordered them to bring back the assets from the offshore trust, and the foreign trustee would not comply.2 This case has been cited by those who do not like the idea of people having property in a place where they cannot get to it as proof that offshore trusts are loosing their ability to protect. It should be noted that the people were subsequently released from jail, and their assets are still in their offshore trust. It should also be noted that no final judgment in the case has been entered: this was all done before any liability on the part of the defendants was determined; such is the power of a court in the U.S.

You can structure your asset protection needs within your legitimate estate and business planning. Offshore trusts are also an effective method to reduce estate taxes, in addition to their asset protection benefits. Use of an offshore trust in connection with estate planning allows for the same kind of tax savings as domestic trusts, while at the same time protecting those very assets from claims of bogus lawsuits. This is what is known as “integrated estate planning.” It does not mean you may create a sham transfer to defeat legitimate creditors; rather, it is a means of incorporating offshore protection as part of your overall estate or business succession plan. The more legitimate tests your planning structures can pass, the less chance that a “badge of fraud” will be found, which could undo everything you have tried to accomplish. It is, therefore, important that you establish these structures for the right reasons. Rest assured the plaintiffs’ attorneys will be prepared to point out the wrong reasons.

Another area of misunderstanding deals with the taxation of income from assets of offshore structures. Many people, attorneys included, mistakenly believe that merely transferring assets to an offshore structure in a jurisdiction which does not have a tax treaty with the United States relieves the settlor/beneficiary from reporting and paying income tax. This is naïve and illegal for a U.S. citizen, or resident. The Internal Revenue Code (IRC) treats income generated from assets held in offshore trusts, for example, where you are the settlor and also the beneficiary the same as if the you received the income, personally, even though you did not actually get any of the proceeds, yourself. This theory is known in tax law as “constructive receipt.” Your failure to report and pay income taxes on income from a trust where the income is deemed to be constructively received is a crime. Offshore trusts, are "tax neutral", and a number of sections of the IRC have been changed, or added in the past several years addressing this.

Schedule B of your 1040 asks the question whether you have set up an international trust, and/or transferred property to an offshore trust (remember, 1040s are submitted virtually under oath, and Schedule B is part of the 1040). Congress enacted legislation in 1996 creating strict reporting requirements on the part of those U.S. citizens creating offshore structures and transferring assets to them.3 This law requires not only you, but also the foreign trustee to file certain forms with the IRS.4 Failure of either you or your trustee to file these forms could subject you to substantial penalties.

The whole purpose for the amendments and additions under the 1996 and 1997 legislation was to make sure that offshore trusts were not being set up to evade the payment of income taxes. The 1996 legislation clearly provides that U.S. persons who set up offshore trusts and make themselves or their relatives the beneficiaries are responsible for declaring and paying tax on income earned by the assets of their trusts.

With all of the tax reporting requirements and the feeling on the part of certain courts that people who have set up offshore trusts or other vehicles, are somehow under suspicion, why would you even want to consider doing this? Obviously plaintiffs and their attorneys would like you to simply give up because it would make their efforts that much more lucrative. We live in a society that has become increasingly litigious. Just look in the "yellow pages" of your telephone book. How often do you see advertisements on television inviting people who have been injured, or believe they have been injured, or feel entitled to someone else's money to retain the lawyer to file suit for them? The recent verdict in the case against the tobacco companies by people who voluntarily smoked with full knowledge of the risks involved in smoking, but who continued to smoke even after it became known that smoking was dangerous should illustrate why asset protection is so important.5

Part of the problem for this is something known as "contingency fees." Historically, contingency fees originated for a good reason. It enabled those who were without sufficient resources to employ an attorney to represent them against those who did have the resources to hire attorneys and defend themselves, namely the railroad barons of the 19th century. Contingency fees were intended to be a "democratic" method by which everyone could have fair representation and thus, a fair chance.

Contingency fees operate quite simply. Most lawyers agree that their fee will be a percentage of the total recovery, usually a third of the total amount recovered, but sometimes higher. The client is not at risk for fees because the agreement also provides that the client doesn't owe the lawyer anything if nothing is recovered. How can the client lose? Lawyers, like anyone else, don't like to work for free. If a lawyer takes a case on a contingency, he or she is generally figuring to get something out of it. With law schools churning out ever more attorneys in the 70's and 80's a strange thing happened. Suddenly there was an overabundance of attorneys. At about the same time restrictions on lawyer advertising were removed. It could now be advertised to people that it wouldn't cost them anything for lawyer's fees unless they got some money, and only then the lawyer's fee would come out of what was recovered: lawsuits abounded, and the theories of liability grew ever more preposterous.

If you have ever been sued, you know that lawsuits are expensive, time-consuming, and for everyone but the lawyers, a major intrusion in your life. Since most defendants are paying out of their pockets, or their insurance company is paying, more often than not, lawsuits are settled, simply as a matter of economy, even if there is no basis for the suit. Many lawsuits are filed not necessarily to find liability, but to obtain a quick out-of-court-settlement. This is much easier to accomplish if the client has assets he/she is concerned could be attached, or are actually attached, pre-judgment. Indeed, litigation is a growing industry in the United States, and more often than not, many of you are targets, or potential targets.

Frequently, even when these cases do go to trial and the defendant wins, attorney's fees are rarely awarded to the successful defendant. The costs to defend yourself can be punitive to say the least, and even though there are remedies on the books to reimburse a defendant if it is later found that the suit did not have merit, or was initiated in bad faith, the costs have to be ordered by the courts, and many judges are reluctant to do this for fear of criticism, or the "chilling effect" such an order could be perceived to have on the filing of any lawsuits, legitimate, or not. Thus, even if you are right, it can cost you a tremendous amount of money just to defend yourself!

Most countries in the world: a) do not allow for contingency fees; and b) make the unsuccessful parties reimburse the successful party for attorney's fees expended in defending a lawsuit, but not in the United States. Most states and the Federal Courts have rules of procedure whereby attorney's fees can be awarded for frivolous litigation, but the judge must authorize this, and awards of fees under this rule are the exception. Thus, the only way you can reasonably protect yourself is to discourage the lawsuit in the first place by removing the financial bull's eye from your chest.

For professionals, the cost of malpractice insurance continues to go up, but many lawsuits that are filed are not for malpractice. You could find yourself being sued for wrongful discharge when you release an employee, or harassment because of some perceived wrong, that either you were alleged to have committed yourself, or permitted to happen because you are the owner of the business, or some kind of other suit which Congress, your state legislature, or some creative plaintiff's attorney has created with a heretofore unforeseen right to recovery (the writer lives in Tennessee---the Tennessee legislature just this year enacted a law giving the owner of a pet the right to bring an action against someone who kills their pet for damages resulting to that person for the loss of the pet's affection--loss of affection typically can involve shock, mental depression, treatment; anything connected to the loss of a "loved one", and the recovery can be quite high). These suits are not covered by insurance, and if you happen to live in many of the States in the southwest, from Texas to California, all of the property which you and your spouse own could be subject to collection of a judgment for the wrong that only one of you was alleged to have committed.

In some states, retirement plans such as IRAs, SEPs, and 401(k), and 403(b) are exempt from being used to pay a judgment, but in others they are not. Other, retirement-type vehicles such as life insurance, tax deferred annuities, accounts held by minors, profit sharing, etc. also depend on local or state law as to whether they are exempt. Does your state provide for this protection? How important is protection of your retirement benefits to you?

Some of the finest money managers in the world, available internationally, choose not to work in the United States because of the frequency of lawsuits, not just those brought by clients, heirs, and anyone else who feels they have a stake, but by the very regulatory agencies which were established to protect the public and oversee the profession. These are inhibitive and costly both to the money manager and the clients for whom the services are rendered. Many of these regulatory agencies are nothing more than bureaucratic morasses, which stifle and actually impede optimum returns. Often in order to obtain the same type of return available from an international manager, a domestic investment must be made in very high-risk ventures. Again, is this what you want?

Financial management is no different than delivery of legal services. Regulation doesn't necessarily guarantee honesty. Regulatory bodies can usually assure the public of rudimentary competency, but honesty cannot be measured by quantitative methods, you either are, or you aren't honest. Choosing a financial manager is much like choosing an attorney. People usually deal with the one they feel the most comfortable with, for whatever reason.

This freedom from fear of litigation allows these international managers to do what they do best (much like physicians who weren't afraid to do what was necessary in order to save the patient, without fear of being sued because they didn't follow the book before malpractice suits became so prevalent) without the attendant costs, which, is always passed on to the investor. One money manager, when asked why he worked off-shore, responded, "I can do everything I can do in the United States, but I don't have to worry about being sued, and as a result, I can do a better job for my clientele."

Given this scenario, is there any way you can: 1) create an effective offshore structure which is both impervious to creditor attacks, and 2) expose you to the global economy that is unavailable in the United States should you so chose?

Offshore structures have been wonderful tools. If properly set up, your assets, or at least those transferred to the international structure will be safe from the claims of these predatory plaintiffs and their attorneys, while affording you over-all estate and business succession planning benefits. This is not an area in which to skimp on fees, however. There is an ever-growing number of those who promise to set you up with wonderful and inexpensive international planning, while making claims that are outright impossible, or even illegal. The Internet is full of these. Unfortunately, some of these "bargains" can be just that. If you are seriously interested, or moved, to investigate international structuring for whatever reason, utilize those professionals who have the background and contacts, not to mention the integrity to properly establish and implement a proper structure that fits your needs, and at the same time is legal and safe.

References

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Author Information

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