

ASSET PROTECTION TRUSTS: AN IMPORTANT INGREDIENT IN THE ESTATE PLANNING PROCESS

The Estate Planner's Perspective of Asset Protection Trusts: An Overview

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1. Introduction

Can, or perhaps more importantly, should estate planning lawyers ethically counsel clients to undertake steps to protect their assets from “future potential creditors”¹ with foreign trusts. If so, to what extent can those trusts be used to protect the assets?

The answer to the question necessarily depends on what is within the scope of asset protection planning from the estate planner's perspective. Is counseling clients on the use of a

*The author gratefully acknowledges the assistance of Richard J. Albrecht, Esq. of Newport Beach, CA in the preparation of this paper.

¹ “Future potential creditors” is a specific term that will be discussed in more detail when the Uniform Fraudulent Transfer Act is discussed later in the paper. See, for example, Barry Engel, “Selected Foreign-based Planning Tools for the Asset Protection Component of the Integrated Estate Plan”, a seminar presented at the Offshore Practice and Procedure Institute, Las Vegas, Nevada (1999). (Hereinafter referred to as “Engel.”)

foreign trust for asset protection planning purposes within the scope of the estate planner?

Asset protection planning has been succinctly defined by William K. Norman, Esq. of Century City, Ca during the recent California Continuing Education of the Bar (“CEB”) Program on asset protection in May of 1999:

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An asset protection plan consists of one or more lawful transfers of assets and/or establishment of structures for holding assets that are primarily undertaken by an individual for estate or business planning reasons and have as a collateral effect the reduction in the risk of future and unforeseen creditors being able to reach the assets transferred or held in the established structures.² (Italics added.)

The answer also depends on the implications of various ethical rules that govern the estate planner’s practice, namely:

Rule 3-210 of the California Rules of Professional Conduct provides that,

A member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule or ruling is invalid. A member may take appropriate steps in good faith to test the validity of any law, rule, or ruling of a tribunal. (Italics added.)

Disciplinary Rule 7-102 of the ABA Model Code of Professional Responsibility provides in part,

DR 7-102 Representing a Client Within the Bounds of the Law.

(A) In his representation of a client, a lawyer shall not:...

- (2) Knowingly advance a claim or defense that is unwarranted under existing law, except that he may advance such claim or defense if it can be supported by good faith argument for an extension, modification, or reversal of existing law.*
- (3) Conceal or knowingly fail to disclose that which he is required by law to reveal...*
- (5) Knowingly make a false statement of law or fact.*
- (6) Participate in the creation or preservation of evidence when he knows or it is obvious that the evidence is false.*
- (7) Counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent.*

² William K. Norman, Esq., CEB Program on Estate Asset Protection Planning, Emerging Issues (May 1999), p. 5.

- (8) *Knowingly engage in other illegal conduct or conduct contrary to a Disciplinary Rule. (Italics added.)*

Rule 7-5 of the ABA Model Code of Professional Responsibility, Ethical Considerations provides,

EC 7-5, A Lawyer as advisor furthers the interest of his client by giving his professional opinion as to what he believes would likely be the ultimate decision of the courts on the matter at hand and by informing his client of the practical effect of such decision. He may continue in the representation of his client even though his client has elected to pursue a course of conduct contrary to the advice of the lawyer so long as he does not thereby knowingly assist the client to engage in illegal conduct or to take a frivolous legal position. A lawyer should never encourage or aid his client to commit criminal acts or counsel his client on how to violate the law and avoid punishment therefor. (Italics added.)

Rule 1.2 of the ABA Model Code of Professional Responsibility provides in part,

RULE 1.2 Scope of Representation

- (a) *A lawyer shall abide by a client's decisions concerning the objectives of representation, subject to paragraphs... (d) and (e),...*
- (d) *A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.*
- (e) *When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer shall consult with the client regarding the relevant limitations on the lawyer's conduct. (Italics added.)*

With the above definition of asset protection planning, the California and ABA Rules of Professional Conduct in mind, deductively it follows that if advising clients about the use of offshore trusts for the protection of their assets from creditors is legal, then the estate planning lawyer should consider advising his or her client about their use.

The legality of using asset protection planning options to protect clients from creditors has been "endorsed" by no less than the U. S. Supreme Court. In Grupo Mexicano³, the U.S. Supreme Court stated in part in its majority opinion that:

³ Grupo Mexicano de Desarrollo S.V. v. Alliance Bond Fund, Inc. (1999) 119 S.Ct. 1961

Despite the dissent's allusion to the increasing complexities of modern business relations and to the bygone age of slow-moving capital and comparatively immobile wealth, we suspect there is absolutely nothing new about debtors trying to avoid paying their debts. ...or even about their seeking to achieve these ends through sophisticated (foreign-haven judgment proofing) strategies. The law of fraudulent conveyances and bankruptcy was developed to prevent such conduct... (Ibid. Emphasis added.)

The implications of the Supreme Court's comment was aptly summarized by Denis Kleinfeld, Esq. in an article in the *Journal of Asset Protection*:⁴

Recently America's highest court handed down a bombshell opinion that is, in my view, an unequivocal endorsement for modern asset protection planning. While the press and some legal practitioners worked themselves into hysteria over a recent, highly fact-specific, 9th Circuit appellate decision known as the "Anderson" case ... that concerned repatriation of offshore trusts assets, the Supreme Court has decided a far more important case, Grupo Mexicano...

So the U.S. Supreme Court has reaffirmed that potential debtors may avail themselves of all asset protections to which the law entitles them, and that to do so is entirely proper. A debtor transferring assets to avoid a creditor, even if he does use "sophisticated strategies," is not only acting within the law, but in the Supreme Court's view, in a way that is "entirely predictable." (Italics added.)

One well known commentator, Duncan E. Osborn, has even gone so far to say that,

ACTEC lawyers probably have a duty to engage in asset protection planning for their clients, but if they do not, then to protect themselves from potential malpractice liability, they should clearly communicate to their clients that their representation does not involve any advice regarding asset protection.⁵ (Italics added.)

It is the purpose of this paper to review a few of the issues facing the estate planner in order to assure him/her of the legality of the use of foreign asset protection trusts.⁶ The very first

⁴ Kleinfeld, *Guidance From the Supreme Court on Asset Protection Planning*, September/October 1999, 5 *Journal Of Asset Protection* 65.

⁵ Osborn, *What ACTEC Fellows Should Know About Asset Protection*, 2000, 25 *ACTEC Notes* 367.

⁶ For a contrary opinion, see Andrew Keltie, *Asset Protection Trusts--If The Game Is Not Up, It Should Be*, Summer 2000, *Asset Protection Journal*.

step for the estate planner, before advising a client about the use of foreign asset protection trusts, is to determine whether or not any transfers would be a violation of the California Uniform Fraudulent Transfer Act⁷ (“UFTA”).

However, before reviewing the UFTA, an overview of a few of the ways that offshore trusts may be utilized for clients by the estate planner is appropriate.

II. An Overview of Foreign and Domestic Asset Protection Planning Options

⁷ See Ca. Civil Code, sections 3439-3439.12.

It is beyond the scope of this paper to review all of the domestic methods of asset protection planning that are available in U.S. jurisdictions.⁸ However, Exhibit A attached is an overview of asset protection strategies structured to more or less show their effectiveness for asset protection purposes currently available. The point of the illustration is that the more protection that a settlor would like, the less control he or she may retain.⁹

Exhibits B through D attached illustrate typical ways that foreign trusts can be used to help protect a client's assets from "future potential creditors". In deciding which structures to utilize for a particular client, certain underlying considerations need to be reviewed and discussed with the client. The client, in effect, must decide how to balance his or needs for control, future access to trust assets or its income, etc. with the effectiveness of the plan's protective features. For example,

1. Will the transfers violate the UFTA? (See discussion, following)
2. Will the transfer make the client insolvent?
3. What assets will be transferred to the various entities.¹⁰
4. Who should be the beneficiaries of the trust? The client, his/her children, a charity?
5. What percentage of the client's assets will be owned by the various asset protection entities? In other words, will trust administration require that frequent or infrequent distributions be made to the client? It is best to plan for infrequent distributions to the client, ergo the "nest egg" approach is preferred.
6. What foreign jurisdiction should be used for the offshore trust?

⁸ See generally, Richard J. Albrecht, Esq., *Potential Asset Protection Benefits of Selected Estate Planning Techniques* in Estate Asset Protection Planning Emerging Issues (Newport Beach, CA in the CEB program, May 1999.)

⁹ For an extensive discussion of domestic asset protection techniques see Henkel, 33rd Annual Philip E. Heckerling Institute on Estate Planning, *Asset Preservation Aspects of Domestic Estate Planning*, 1999. (Hereinafter referred to as "Osborn").

¹⁰ Note that the assets should be held physically in the foreign jurisdiction to provide increase protection from U.S. creditors.

7. Does the foreign jurisdiction provide certainty for creditor actions (i.e. a clearly defined statute of limitations, limits on the ability of creditors to reach trust assets and the burden of proof is on the creditor)?
8. What are the tax ramifications of the trust domiciled in the selected foreign jurisdiction?
9. Is the foreign jurisdiction easily accessible (i.e. speak English, time zone, etc.), stable and utilize trust structures in its legal system?
10. The foreign jurisdiction does not recognize U.S. judgements (i.e., no comity).
11. Should the protector be onshore or offshore?
12. Should the trust contain a “flee clause”?
13. Will the trust be a foreign trust for U.S. tax purposes? (see discussion following)

In helping the client make his/her choices, the estate planner needs to keep in mind the ways creditors can be expected to attack the plan and, if appropriate, relate the focus of these potential attacks to the client. Commentators have cited a number of ways that clients can expect to have their asset protection plans attacked.¹¹ For example, a few of the more common ways that creditors may attack asset-protection structures are as follows:

1. A violation of the UFTA;
2. The assets were not properly transferred to the entities or to the offshore jurisdiction;
3. The foreign trust was established or the assets transferred thereto too close in time (i.e. a nexus in time) to the creditor’s action and the court’s order to pay so

¹¹ See for example, Alan R. Jahde and Michael P. Franzmann, *Creditor’s Rights Against Asset Protection Trusts*, January/February 2000, *Journal of Asset Protection*; as well as Barry S. Engel, *Determining Whether A Creditor Can Access Assets In An Offshore Trust*, September/October 1995, *Journal of Asset Protection*.

- that the defense of “impossibility of performance” will be ineffective;¹²
4. Funds that were transferred to the foreign trust were fraudulently obtained;¹³
 5. The history of trust administration shows that the settlor maintained a level of control over the trust assets that made the trust his/her alter ego;
 6. Trust Protector with any affirmative powers is subject to U.S. jurisdiction;¹⁴
 7. Poor choice of foreign jurisdiction for the trust’s domicile;¹⁵

¹² See, for example, Anderson, *op. cit.*

¹³ See, for example, Grupo Torras S. A. et. al. v. Sheik Fahad Mohammed Al Sabah et. al., September 1, 1995, Supreme Court of the Bahamas; and Federal Trade Commission v. Affordable Media, (CA-9, 1999)179 F3rd 1228 (hereinafter referred to as the “Anderson” case).

¹⁴ See, for example, J. Ben Vernazza, *The Independent Protector in Overseas Trusts*, January/February 2000, Journal of Asset Protection.

¹⁵ For a good discussion of selecting the proper foreign jurisdiction, see Osborn,

8. The foreign bank holding the assets or its parent or affiliate has a U.S. presence;¹⁶
9. Failure to be forthright when a creditor or bankruptcy investigation is instituted;¹⁷

Before the estate planner can begin to set up the structures for asset protection, the planner must be certain that by transferring assets to a foreign trust, the client does not violate the California UFTA.

III. The California Uniform Fraudulent Transfer Act¹⁸: Its Criminal Implications For Advisors and Clients

In addition to the possible ethical violations previously cited, the criminal penalties that can be asserted against advisors violating the UFTA, even inadvertently, can be severe. California Penal Code Section 531 provides in part that,

Every person who is a party to any fraudulent conveyance of any lands, tenements, or hereditaments, goods or chattels, or any right or interest issuing out of the same, or to any

¹⁶ See for example, United States v. Bank of Nova Scotia (11th Cir. 1984) 740 F.2d 817.

¹⁷ See, for example, United States Crimes and Criminal Procedure Code, tit. 18 section 152, which provides for up to five years imprisonment plus a fine if a person knowingly conceals assets, makes a false oath or claim. See also John E. Sullivan III, *The Often Overlooked Role of Disclosure in Asset Protection Planning: Part I*, Spring 2000, Asset Protection Journal.

¹⁸ Cal. Civ. Code sections 3439-3439.12. A version of the UFTA is also found in the Bankruptcy Code at 11 U.S.C. 548.

bond, suit, judgment, or execution, contract or conveyance, had, made, or contrived with intent to deceive and defraud other, or to defeat, hinder, or delay creditors or others of their just debts, damages, or demands...is guilty of a misdemeanor. (Emphasis added.)

At a minimum, the estate planning lawyer needs to determine if the proposed transfer will make the settlor insolvent because insolvency is the most important factor in determining whether a transaction is a fraudulent conveyance¹⁹. The Insolvency is determined to exist when

¹⁹ See Peter Spero, *Asset Protection: Legal Planning and Strategies*, published by Warren Gorham & Lamont, published in 1994, updated annually at 3.04(1)(c), pages 3-23. (Hereinafter referred to as “Spero”.)

the settlor's assets, at fair value,²⁰ exceed his/her liabilities²¹ within the meaning of Ca. Civ. Code Section 3439.02.

The importance of being sure that the client is solvent before and after the asset protection plan is established was succinctly stated in the treatise by Peter Spero,

*One of the reasons it is absolutely essential for the attorney to determine the solvency of a client is that any gift or similar transfer made by the client pursuant to an asset protection plan that occurs when the client is insolvent [footnote omitted] or will be rendered insolvent constitutes constructive fraud [footnote omitted]. In such circumstances, the transfer will be voidable, the client may be denied discharge in bankruptcy [footnote omitted], and the attorney may be subject to civil, criminal, and disciplinary action [footnote omitted]. The rule applies regardless of the presence or absence of fraudulent intent [footnote omitted].*²² (Italics added.)

As mentioned in Spero, supra, estate planners may also be civilly liable to a client's creditors if the planner participated in the fraudulent conveyance. For example, in *Durant Software v. Herman*,²³ the California court held that an attorney who fraudulently injured a third

²⁰ "Fair value" as used in the UFTA generally is considered to mean the amount that can be realized within a reasonable time. See Spero at 3.04(1)(c)(i), pages 3-27.

²¹ Contingent liabilities are included as part of the overall determination of liabilities but are discounted to reflect the probability that the contingency will materialize. See Spero at 3.04(1)(c)(ii), pages 3-29.

²² See Spero at 3.04(2)(b), pages 3-40.

²³ *Durant Software v. Herman*, (1989) 257 Cal. Rptr. 200, 208; appeal dismissed, (1990)

party by acting in furtherance of a conspiracy to defraud a creditor is not relieved from liability merely because he was acting in the capacity of attorney.

Asset protection advisors would do well to also point out to their clients that any fraudulent conveyance that they may so enter is also subject to criminal penalties. California Penal Code Section 154²⁴ provides that,

(a) Every debtor who fraudulently removes his or her property or effects out of this state, or who fraudulently sells, conveys, assigns or conceals his or her property with the intent to defraud, hinder or delay his or her creditors of their rights, claims, or demands, is punishable by imprisonment in the county jail not exceeding one year, or by fine not exceeding one thousand dollars (\$1,000), or by both that fine and imprisonments.

(b) Where the property so removed, sold, conveyed, assigned, or concealed consists of a stock in trade, or a part thereof, or a value exceeding one hundred dollars (\$100), the offense shall be a felony and punishable as such. (Emphasis added.)

IV. Selected Terms of the Uniform Fraudulent Transfer Act.

Because of the liabilities faced by all parties in the preparation of an asset protection plan, it is, of course, necessary that the estate planning lawyer have a thorough understanding of the UFTA. While a thorough discussion of the relevant aspects of the UFTA is beyond the scope of this paper, an overview of UFTA terms is in order.

The focal provisions of the UFTA are set forth in Sections 3439.04, 3439.05 and 3439.09 of the California Civil Code. Section 3439.04 provides in part that,

Section 3439.04. Transfer with intent to defraud or transfer not given in exchange for value.

A transfer made... by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made... if the debtor made the transfer ... as follows:

(a) With actual intent to hinder, delay, or defraud any creditor of the

272 Cal. Rptr. 612.

²⁴ See also California Penal Code Section 155 which provides in part for imprisonment for up to one year for the fraudulent concealment of property. In addition, 18 USC Sections 152 and 157 provide that concealment during a bankruptcy will also be subject to criminal sanctions.

debtor.

(b) *Without receiving a reasonably equivalent value in exchange for the transfer..., and the debtor:*

(1) *Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or*

(2) *Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.” (Emphasis added.)*

Section 3439.05 provides in part that,

3439.05. Transfer resulting in debtor’s insolvency.

A transfer made... is fraudulent as to a creditor whose claim arose before the transfer was made...if the debtor made the transfer...without receiving a reasonably equivalent value in exchange for the transfer...and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer....” (Emphasis added.)

Section 3439.09 sets the statute of limitations for actions filed under the UFTA. Section 3439.09 provides in part,

3439.09 Time within which action must be brought.

*A cause of action with respect to a **fraudulent transfer... is extinguished unless action is brought...***

*(a) Under subdivision (a) of Section 3439.04 (i.e. intent to hinder, delay, or defraud), **within four years after the transfer was made... or, if later, within one year after the transfer...or could reasonably have been discovered** by the claimant.*

*(b) Under subdivision (b) of Section 3439.04 or Section 3439.05 (i.e. not receive reasonably equivalent value and about to engage... or incur debts or insolvent), **within four years after the transfer was made....***

*(c) Notwithstanding any other provision of law, a cause of action with respect to a **fraudulent transfer... is extinguished if no action is brought or levy made within seven years after the transfer was made...**” (Emphasis added.)*

The general remedy for a creditor if the court finds that a fraudulent conveyance occurred is that a creditor can have the conveyance set aside.²⁵

V. Application Of The Uniform Fraudulent Transfer Act.

²⁵ See Cal. Civ. Code Section 3439.07

The application of the UFTA can be best understood if one views the statute as a two step test that must be satisfied before a transfer will be subject to its terms and set aside. The first test is to determine whether or not the creditor in question is, in fact, a covered creditor. The second test is to determine whether or not the transfer was fraudulent conveyance within the meaning of the statute.²⁶

Step 1: Is the creditor a covered creditor?

²⁶ See specifically Cal. Civ Code Sections 3439.04 and 3439.05, *supra*.

A collision in legal interests exists between the language of the UFTA in section 3439.4 and fundamental concepts in common law about the free alienability of property by an owner. The literal language in section 3439.4, “*whether the creditor’s claim arose before or after the transfer was made...*” seems to imply that every creditor of a debtor whether a present or future creditor would be protected under the provisions of the UFTA. However, “nowhere is it written that one must preserve one’s assets for unknown future creditors... and the law simply does not require one to put all of one’s assets at risk.”²⁷ The tension between the two areas has resulted in a somewhat narrow interpretation by courts of which creditors are protected by the UFTA.

For our purposes, it can be said that there are three types of creditors that the asset protection planner must consider, all revolving around the time the claim came into existence, namely: (1) present creditor, (2) future or subsequent creditor, and (3) future potential creditor²⁸. A claim is deemed to be in existence if there is “a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”²⁹

What is the meaning of each of the three categories of claimants and how do they interrelate to the applicability of the UFTA? As mentioned above, there are essentially three types of creditors that can be defined as follows:

- (1) “Present creditors”, as dictated by section 3439.4, is where the claim arose before the transfer in question. Present creditors are covered by the terms of the UFTA.
- (2) “Future or subsequent creditors” are defined as creditors who claim arose after the transfer in question and there was a foreseeable connection between the creditor and the settlor at the time of the transfer. As Peter Spero has opined,

(T)he term ‘future creditors’ is narrowly defined. In fact, in this context, the term may be a misnomer, because it generally means a creditor who presently holds contingent, unliquidated, or unmatured claims, all of which are included in the definition of the term ‘claim’ under the (UFTA). If the transfer is made with the requisite fraudulent intent directed toward a future creditor, then such intent must be contemporaneous with the transfer, or there must be some other connection between the two elements so that it can be said the transfer is intended to injure the future creditor (footnote omitted). A person whose claim arises after the fraudulent transfer can qualify as a future creditor capable of

²⁷ See Osborn.

²⁸ See Engel at page IX-7.

²⁹ See Ca. Civ. Code Section 3439.01(b).

*voiding the transfer as fraudulent if the 'transfer was made with the intent to defraud **that particular creditor** [footnote omitted].³⁰ (Italics added.)*

Duncan Osborn in a somewhat more expansive view has opined that,

³⁰ See Spero 3.04(1), pages 3-16.

*(T)his is the kind of creditor that a client could reasonably expect to face given his or her ordinary method of conducting business. That is, the creditor must be reasonably foreseeable. In this category, intent (either actual or constructive) becomes critical.*³¹ (Italics added.)

Future or subsequent creditors are covered by the terms of the UFTA.

- (3) “Future potential or unknown creditors” can be defined as those creditors whose claim arose after the transfer in question and there was no foreseeable connection between the creditor and the settlor at the time of the transfer. In other words, as stated by Peter Spero,

*(I)f a transfer is not made to defraud a specific person who does not currently hold a claim against the debtor, it will not be set aside (footnote omitted).*³² (Italics added.)

The Pennsylvania Appeals court has stated in *Leopold v. Tuttle*³³ the meaning of “future creditor” as used under Pennsylvania’s UFTA as follows:

While the definition of a ‘present creditor’ is more self-explanatory, the definition of a ‘future creditor’ is much more ambiguous. In Stauffer v. Stauffer, (cite omitted), the Pennsylvania Supreme Court defined a ‘future creditor’ as:

‘One with a legal claim against a person at the time that the person makes a conveyance, even one that has not yet been reduced to judgment or even filed, is a future creditor who is entitled to set aside the conveyance if he can show it was made with actual intent to hinder, delay, or defraud present or future creditors.’

*Other Pennsylvania courts have construed the term ‘future creditor’ to mean not only a creditor whose claim has not matured but a creditor whose claim is reasonably foreseen as arising in the immediate future. (Cite omitted) **In short, a***

³¹ See Osborn, pages 13-4.

³² See Spero 3.04(1), pages 3-17.

³³ 378 Pa. Super. 466; 549 A2nd 151 (1988).

*'future creditor' does not exist unless a conveying party can reasonably foresee incurring the costs of a claim or judgment at the time of the conveyance.*³⁴ (Emphasis added.)

Future potential or unknown creditors are not protected by the UFTA and, as such, are the kind of future creditor an asset protection plan is established to protect from since the assets being transferred to the foreign trust are free of claims at the time of the transfer.

Step 2: Is (was) the transfer a fraudulent conveyance?

Assuming that the creditor is either a present or future creditor as those terms are defined in Step 1, above, the question is what kind of a transfer would be set aside under the UFTA.

It is generally understood that there are two types of fraudulent transfers within the meaning of the UFTA: actual intent to defraud, and constructive fraud shown by economic circumstances.

Actual Intent

The first type of fraudulent transfer, as defined by section 3439.04(a), is a transfer with “actual intent to hinder, delay, or defraud any creditor of the debtor”. In other words, actual fraud focuses on the intent of the settlor at the time of the transfer and the presence or absence of bad intent is the sole criteria. No matter what the financial situation of the settlor or even if the settlor received adequate consideration at the time of the transfer, if it can be shown that the settlor has an actual intent to hinder, delay or defraud the creditor, the transfer can be voided.

³⁴ Ibid at 5.

To prove actual fraud, the courts have adopted certain “badges of fraud” that are used to help show that the settlor had actual intent to hinder, delay or defraud the creditor.³⁵ No presumption of fraud arises if a transfer has various badges of fraud as the trier of fact must make its own determination. The badges of fraud usually must be present at the time of the transfer.

1. The transfer was to an insider. (As all estate planners know, gifts are an important tool to help save estate taxes. Generally, estate planners give little thought to issues presented by the UFTA when designing a gifting program for their clients, but caution should be exercised since such gifts could be voided by a creditor up to 7 years after the gift!)
2. The transfer was concealed.
3. The settlor retained possession or control of the property transferred after the transfer. (The simple act of transferring assets to trust wherein the settlor remained a beneficiary is itself a badge of fraud.)
4. The transfer was made after the settlor had been sued or threatened with a suit.
5. The transfer was of substantially all of the debtor’s assets. (This is one reason that the amount of a transfer to a foreign trust would be only those assets that represent a “nest egg” of the settlor.)
6. The settlor removed or concealed assets. (A transfer of assets offshore may thus be deemed to be a badge of fraud.)
7. The settlor was insolvent or became insolvent shortly after the transfer was made. (This may be one of the most important factor in determining whether or not a transfer is voidable for not only actual fraud but also constructive as herein after discussed.)
8. The transfer occurred shortly before or shortly after a substantial debt was incurred.

³⁵ The reader is directed to Uniform Fraudulent Transfer Act, section 4(b) and comment (1) for a more extensive list of the badges of fraud developed by the courts. See also Spero, 3.04(1)(b) pages 3-20.

Constructive Intent

The second type of fraudulent transfer, as defined by sections 3439.04(b)(1), 3439.04(b)(2), and 3439.05 (see discussion in Section IV of this paper) is a transfer made without reasonably equivalent value in one of three situations:³⁶

1. “Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction;” (3439.04(b)(1))
2. “Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due;” (3439.04(b)(1))
3. “(T)he debtor was insolvent at that time or the debtor became insolvent as a *result of the transfer;*”(3439.05)“ (Italics added.)

In addition, the allegedly constructively-fraudulent transfer must have had a causal connection between the transfer and the creditor’s claim. The requisite causal connection cannot be established merely by showing a chronological relation between the suspect transfer and the settlor’s insolvency. Thus, if the settlor can show evidence of unforeseen intervening acts that cause or contribute to insolvency, the UFTA will not act to void the transfer.³⁷

VI Tax And Selected Reporting Considerations For Asset Protection Trusts

³⁶ It should be noted that no actual fraudulent intent is required.

³⁷ See Spero 3.04(2), page 3-32.

An offshore asset protection trust properly drafted for a U.S. citizen settlor will be tax neutral for income and estate tax purposes. The purpose of this discussion is only to provide the estate planner an overview of a foreign trust's income and estate tax consequences as well as the tax reporting requirements. (It is beyond the scope of this paper to thoroughly analyze the estate and income tax aspects of foreign trusts.³⁸)

The reasons a properly drafted foreign trust is tax neutral can be briefly summarized as follows:

1. An offshore trust with a foreign trustee will be treated as a foreign trust for tax reporting purposes.

The Small Business Job Protection Act of 1996 changed the definition of "foreign trust". Under new Code Section 7701(a)(30)(E)³⁹ any trust will be a US trust if--

- (i) *a court within the United States is able to exercise primary supervision over the administration of the trust, and*
- (ii) *one or more United States persons have the authority to control all substantial decisions of the trust.* (Italics added.)

Code Section 7701(a)(31)(B) provides in part that,

- (B) *Foreign trust. The term "foreign trust" means any trust other than a trust described in subparagraph (E) of paragraph (30).* (Italics added.)

Treas. Reg. Section 301.7701-7 provides that a trust is a U.S. person on any day that the trust meets both the "court test" and the "control test". In other words, a trust will be a "foreign

³⁸ For a thorough discussion of the income tax consequences of an offshore trust see Carlyn S. McCattrey *et.al.*, ALI-ABA International Trust and Estate Planning Conference, San Francisco, CA, U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors, and Their U.S. Beneficiaries, August 3-5, 2000.

³⁹ References in this paper to "Code Section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code".)

trust” if it has a foreign trustee, which usually for asset protection purposes will have at least one foreign trustee, with usual fiduciary powers or even very limited powers as long as the foreign trustee can make one “substantial decision”.

Treas. Reg. Section 301.7701-7(d)(1)(ii) provides a laundry list of decisions that are deemed “substantial decisions”. The section provides in part, that

(S)ubstantial decisions” means all decisions, other than ministerial decisions that any person, whether acting in a fiduciary capacity or not, is authorized...to make under the terms of the trust instrument or applicable law. Such decisions include, but are not limited to:

- a. *The timing and amount of distributions;*
- b. *The selection of beneficiaries;*
3. The power to determine whether receipts are allocable to income or principal;
4. The power to terminate the trust;
5. The power to compromise, arbitrate, or abandon claims of the trust and to decide whether to sue on behalf of or defend suits against the trust;
6. The power to remove, add or replace a trustee; and
7. The power to make investment decisions. (Italics added.)

Caution: If a U.S. trust has a change in trustee from a U.S. person to a foreign person, the trust will be reclassified as a foreign trust with attendant reporting requirements as herein after discussed.

2. The trust will be treated a grantor trust and all of the trust income will be included in the income of the settlor in accordance with Code Section 671.

Generally, a foreign asset protection trust is set up such that the settlor (US person), his or her spouse, and/or his or her issue are beneficiaries thereof. If any one of the beneficiaries or just the Settlor alone is a U.S. person within the meaning of Code Section 7701(a)(30)(A), then the trust will be grantor trust.⁴⁰ The test to determine whether a foreign trust has a U.S. beneficiary is done on a year by year basis.

3. Transfers to the foreign trust by the U.S. Settlor are tax free.

Code Section 684(b) is an exception to the general rule of Code Section 684(a) which treats all transfers to a foreign trust as a sale or exchange of the assets so transferred. Section 684(b) provides that,

⁴⁰ See Code Section 679.

(b) Exception

Subsection (a) shall not apply to a transfer to a trust by a United States person to the extent that any person is treated as the owner of such trust under section 671. (Italics added.)

4. No income taxes due on the death of the settlor of the foreign grantor trust.

The death of a U.S. settlor who was treated as the owner of a foreign trust during his or her lifetime will not be a gain recognition event. Proposed Reg. Section 1.684-3(c) provides in part,

(c) Certain transfers at death. The general rule of gain recognition under section 1.684-1 shall not apply to any transfer of property by reason of death of the U.S. transferor if such property is included in the gross estate of the U.S. transferor for Federal estate tax purposes and the basis of the property in the hands of the foreign trust is determined under section 1014(a). (Italics added.)

5. After the death of the U.S. settlor of the foreign grantor trust, the trust may become a foreign non-grantor trust if it stays offshore.
6. A foreign trust has significant reporting requirements.⁴¹

A U.S. person who creates a foreign trust or who transfers property to a foreign trust (and/or any U.S. beneficiary who receives a distribution from a foreign trust⁴²) is required to report the creation or transfer on Form 3520⁴³ at the time that the settlor's income tax return is due.⁴⁴ **If Form 3520 is not timely filed, the settlor will be subject to a penalty equal to 35% of the amount transferred.**⁴⁵

The foreign trust is required to report on Form 3520A which is due by March 15 following the year for which reporting is required. If the trust fails to timely file Form 3520A, the settlor is

⁴¹ For a more thorough discussion of the reporting requirements for a foreign trust see Richard A. Westin and Norman Axten, *Foreign Trusts That Do Not Comply With U.S. Reporting Requirements*, July/August 1999, *Journal of Asset Protection*.

⁴² See Code Section 6048(c).

⁴³ Code Section 6048(b).

⁴⁴ Note that Code Section 6048(b)(2)(B) also requires the foreign trust to appoint a U.S. agent.

⁴⁵ Code Section 6677(a).

liable for a penalty of up to 5% of the value of the trust assets that are treated as owned by the settlor.

VII. Conclusions

A properly drafted, implemented and administered foreign asset protection trust is a viable option for estate planning advisors to present, perhaps even required, to their clients as another tool to be used to satisfy his or her estate planning needs.

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