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## Advanced Planning with Foreign Trusts

### A. Offshore Defective Grantor Trusts

#### 1. Defective Grantor Trusts Generally

An installment sale to a defective trust<sup>1</sup> in exchange for the trust's promissory note has become an increasingly popular estate transfer strategy with many significant benefits.<sup>2</sup> Generally, this technique is used to sell non-controlling interests in entities to the trust, while taking advantage of the valuation discounts and freezing the value of the estate.

The trust is drafted as an irrevocable dynasty trust, but intentionally violating one or more of the grantor trust rules under Code Section 671. Most frequently, the trust is made defective for income tax purposes by appointing the grantor as the trustee of the trust.<sup>3</sup> With respect to the appointment of the trustee in this setting there is an often exploited distinction between the attribution rules for estate tax and income tax purposes. For example, if the grantor's spouse is appointed as a trustee with the power to sprinkle income among beneficiaries, that power is not attributed to the grantor (but the trust must be funded with the grantor's separate property, not community property of the spouses). However, the powers held by the grantor's spouse is attributed to the grantor for income tax purposes.

The note is typically structured as interest-only, with a balloon payment at the end. The note should bear an adequate rate of interest, determined under Code Section 7872. In Revenue Ruling 85-13, 1985-1 C. B. 184, and several private letter rulings, the Service ruled that the sale of property by the grantor to the trust will be ignored for income tax purposes, because the grantor trust is a disregarded entity.

Because the trust is irrevocable, and is otherwise drafted to be outside of the grantor's estate, the property placed in the trust escapes estate taxation. To ensure this result and prevent the application of Code Section 2036 the grantor should set the trust up for someone else's benefit, *i.e.*, children. To avoid the application of the gift tax, the discounted value of property sold to the trust should equal the fair market value of the note.

Because the anti-freeze rules of Code Section 2702 may apply to a defective grantor trust it may be advisable to pre-fund the trust with assets equal to 10% of the value of the property that will be sold to the trust.

The property within the trust continues to appreciate in value, while the value of the promissory note is fixed (the note earns a constant rate of return that is usually lower than the rate of appreciation of the assets within the trust). The value of the note will be included in the grantor's estate. Leveraging the life-time estate and gift tax exclusion, and by discounting the value of partnership or LLC interests placed in the trust creates significant

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<sup>1</sup> These defective grantor trusts are sometimes referred to as "intentionally" defective grantor trusts. The author believes the word "intentionally" to be redundant, because a trust would not be drafted as defective unless it was intentionally (barring acts of malpractice).

<sup>2</sup> Defective grantor trusts are viewed as being superior to GRATs because there is no requirement that the grantor outlive the trust, and because the GST exemption may be claimed upfront.

<sup>3</sup> One planning element commonly incorporated into defective grantor trust is the ability to switch trustees, appointing an independent third party as the trustee. When that happens, the trust ceases being a grantor trust. Likewise, an independent third party trustee can be removed and the grantor appointed trustee, with the trust switching back to grantor mode.

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estate tax savings. Additionally, because income taxes are paid by the grantor and do not constitute a gift to the trust,<sup>4</sup> additional wealth is shifted from the grantor's estate and into the trust.

A defective grantor trust would work particularly well for a start up business or a new business opportunity. A start up business, with low initial value but great upside potential, can be transferred to the trust at minimum value, with all the business growth occurring within the trust, and outside the settlor's estate.

As a matter of fact, a business opportunity within a defective grantor trust calls for a slightly different structure to be optimally efficient. Where the trust requires little seed money to start the new business, it is advisable to have a client's parent, sibling or other party seed the trust, with the client named as beneficiary. So long as the client is not treated as the grantor of the trust, Code Section 2036 issues do not arise. The client can then act as the trustee of the trust, and will be the primary beneficiary.

As the trust makes interest payments on the note to the settlor, the settlor does not take the payments into income, as the transaction is ignored for income tax purposes. However, it is unclear what happens on the death of the settlor when the trust loses its grantor status, and the payments become taxable. Does the settlor's estate begin to recognize income? The answer is not entirely clear. It has been suggested that on the initial sale the settlor elect out of the installment method, thus accelerating all the gain realization on the sale. However, because at the time of the sale the trust has grantor status, the gain is not actually taxable to the grantor. At the time of death, the argument goes, there is no gain left to recognize. While there is no authority on this point, this strategy may work, and because there is no downside risk, the election out of the installment method should always be undertaken.

It is also possible to pay off the note prior to the settlor's death when the trust still has its grantor status. It is advisable in that case to pay off the note with highly appreciated assets which will get a step-up in basis on the death of the settlor. The assets within the trust will not get a step-up in basis on the grantor's death, which should be taken into account when evaluating the benefits of a defective grantor trust.

## 2. Asset Protection Benefits of Defective Grantor Trusts

Although the grantor would be treated as owner of the trust for income tax purposes, he would clearly not have legal or equitable title to the trust's assets. Consequently, trust assets would not be available to the settlor's creditors, unless the trust was treated as a self-settled trust. Because grantors are usually not beneficiaries of defective grantor trusts to avoid inclusion of trust corpus under Code Section 2036, the trust should not be treated as a self-settled trust.

The trust can further be drafted as a spendthrift or a discretionary trust. Further, because the note received from the trust is an interest-only, balloon note, the payment to a creditor of the grantor can not be accelerated.

Another alternative is to draft the note so that it is personal to the settlor and nonnegotiable. It is possible that making the note nonnegotiable will reduce its value. In that case the face amount of the note should be increased to ensure that the fair market value of the note equals the value of the property transferred to the trust.

## 3. Offshore Defective Trusts

An intentionally defective trust with an offshore situs has two advantages.

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<sup>4</sup> A discharge of one's legal obligation is not a gift.

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First, many offshore asset protection jurisdictions have repealed the law against perpetuities, making it possible to set up the trust as a dynasty trust. A dynasty trust can be set up to benefit multiple generations, while being subject to the estate and GST taxes only on the initial funding.

Second, a foreign trust may make it easier to change the trust's status as grantor or non-grantor. In a defective grantor trust the grantor transfers most of his or her assets to the trust, but continues to pay taxes on trust's income. While that is usually very advantageous, it is possible that the grantor will eventually exhaust his or her non-trust assets and will be unable to pay taxes. In that case it may be beneficial to change the trust's status to non-grantor. While that may be accomplished by having the grantor relinquish certain powers, it is even easier to accomplish by changing the trust's classification as foreign or domestic for tax purposes.

If a trust is foreign for tax purposes and has a U. S. beneficiary, it is always a grantor trust. It is relatively simple to reclassify a foreign trust as domestic for tax purposes – simply switching to a U. S. trustee and subjecting the trust to the concurrent jurisdiction of a U.S. court should be sufficient. If the trust is not otherwise drafted as a grantor trust under Code Section 671, it will switch to the non-grantor status.

## ***B. Offshore Trust and Entity Combos***

### **1. Generally**

Foreign trusts are most effective when they hold foreign assets. As discussed above, with a stroke of a pen a judge can vest in the creditor any U. S. asset of the debtor, even if the asset is titled in a foreign trust.

However, while that is possible, it does not happen often, and should not happen if the planning is done timely, without concealing any aspects of the plan. Assuming that the trust will not be disregarded by a judge as being separate from the debtor, or simply ignored, what is the best way for the trust to hold U. S. based assets?

For cash and marketable securities, the trust can just hold the assets directly, because they can be moved offshore quickly. The same is not true for real estate or a business operated within the U. S. In that case it is important to ensure that (i) the choice of law analysis points offshore, and (ii) when the real estate is liquidated, the proceeds go offshore.

The best way to achieve both of those goals is by holding the real estate through a limited liability company organized offshore. This structure has the additional benefits of availing the client of the valuation discounts found in an LLC,<sup>5</sup> and obtaining the additional asset protection by way of the LLC charging order statute of the jurisdiction where the entity is organized.

### **2. Foreign LLCs**

Many foreign jurisdictions have enacted LLC statutes. A lot of these jurisdictions are so-called tax havens, which generally means that an entity organized in that jurisdiction will not be taxed by that jurisdiction if the entity is not conducting any business in the jurisdiction. If a U. S. business or U. S. real estate is owned by an entity organized in a tax haven, the entity will not be doing any business in the tax haven and will not be taxed there.<sup>6</sup>

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<sup>5</sup> Obtaining a valuations discount by using an LLC is a complex area of law, based primarily on the Code Section 2036 analysis, and is outside the scope of this outline.

<sup>6</sup> Although the entity will not be "taxed" by the jurisdiction, it will still be subject to annual registration fees.

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In most offshore jurisdictions with LLC statutes, the LLC laws are similar to the U. S. state LLC laws. Thus, LLC members enjoy limited liability, and the protection of the charging order. Additionally, many offshore jurisdictions provide that the charging order is the sole remedy of the creditor, with no right to foreclose.

Pursuant to the traditional choice of law analysis, the law of the jurisdiction where an entity is organized will govern the entity, even if the business is transacted elsewhere. For example, California Corporations Code Section 17450(a) provides:

The laws of the state or foreign country under which a foreign limited liability company is organized shall govern its organization and internal affairs and the **liability and authority of its managers and members**. [Emphasis added.]

The only time when this choice of law will not be respected is when the application of the laws of the foreign jurisdiction will violate the public policy of the state where the LLC is conducting business. Because the LLC statutes of offshore jurisdictions are very similar to the U. S. LLC statutes, it is unlikely that the offshore statutes will be ignored for public policy reasons.

Thus, as opposed to exporting the assets to a foreign jurisdiction, a foreign LLC allows to import the law. While the asset protection safeguard is not as high, for many debtors it may be the only viable option.

This means that if a California resident organized a Nevis LLC to hold Idaho real estate, a creditor attempting to collect against the California resident would have to rely on the Nevis charging order statute. The Nevis charging order statute limits the creditor to the charging order, with no right to foreclose.<sup>7</sup>

It is important to remember that a foreign entity that does not want to be taxed as a corporation for U. S. tax purposes should make an affirmative election to be taxed as a partnership by filing Form 8832.

Some U. S. jurisdictions (like, Nevada) similarly restrict creditors to the charging order, with no right to foreclose. What is the advantage of a foreign LLC to a domestic LLC all else being equal?

The advantages are: (i) extra costs and expenses incurred by a creditor in pursuing a debtor to a foreign jurisdiction, and (ii) the favorable asset protection laws of the foreign jurisdiction. Particularly if the jurisdiction, like the Cook Islands, does not recognize U. S. judgments.

### 3. Combining Foreign Trusts and Foreign LLCs

Combining an LLC and a trust, both organized offshore, has advantages for both entities.

In this structure, the foreign trust is the sole member of an LLC, or, at the very least, the trust holds a super-majority interest in the LLC. This provides further insulation to the assets within the LLC, because now a creditor has to first penetrate the foreign trust, second, obtain a charging order against the LLC and then collect on the charging order. Steps two and three are not easy to accomplish, but are possible. Step one, penetrating the foreign trust, is possible technically, but not practically.

The use of a foreign LLC also has advantages for debtors planning with foreign trusts. For a debtor to avail itself of the impossibility defense in a contempt situation, the debtor must not have any control over trust assets. However, if the trust owns the LLC, and the debtor is appointed as the LLC's manager, without an ownership interest, the debtor can control the assets, without being in control of the trust.

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<sup>7</sup> Nevis Limited Liability Company Ordinance Section 43.

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In the event of threatened litigation the debtor can be either removed as the manager of the LLC, or, preferably, the LLC agreement should give the trust veto power over certain distributions, actions and decisions by the manager. For example, the trust should have veto power over liquidation of the LLC, a distribution exceeding a certain amount, or issuance of a membership interest to a new member.