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Foreign Trusts

A. Overview

Even if the settlor of a domestic asset protection trust (“DAPT”) resides in the DAPT jurisdiction and all the assets of the trust are located in the DAPT jurisdiction, the efficacy of a DAPT may be challenged under the Supremacy clause of the U.S. Constitution, under the applicable fraudulent transfer statute, or because the settlor retained some prohibited control over the trust.

The only possible way of avoiding all these obstacles when planning with trusts is through the means of a foreign trust. A foreign trust, *per se*, does not have any asset protection benefits. The benefits come from the jurisdiction which governs the trust. Several jurisdictions compete in the foreign trust arena and have drafted their trust laws to address all or most of the problems and issues discussed above.

The commonly understood meaning of the term “foreign trust” is a trust governed by the laws of a foreign jurisdiction. However, as discussed below, the term “foreign trust” has a very specific meaning under the Code. Whenever the term “foreign trust” appears in this text, it refers simply to a trust governed by the laws of a foreign jurisdiction.

Foreign trusts are truly efficient for asset protection purposes only if liquid assets are used to fund the trust, and such assets are, at some point, transferred offshore. While a foreign asset protection trust can hold any property, including personal and real property in the U. S., the ability of a U. S. court to reach U. S. property suggests the benefits of holding offshore assets in the foreign trust.

Foreign trusts are usually treated as “foreign trusts” for the purposes of the Code. This means that transfers of assets to the trust will be treated as a sale for tax purposes. To avoid the sale treatment on the funding of the trust, most foreign trusts are drafted as grantor trusts. Being grantor trusts, they avoid sale treatment on funding, and remain tax neutral during their existence. Foreign asset protection trusts are usually established solely for asset protection purposes, and almost never for tax purposes.

Generally, when contrasted with a domestic trust, a foreign trust offers the following benefits:

1. Increased ability of the settlor to retain benefit and control;
2. Less likely to be pursued by a creditor;
3. Foreign jurisdictions usually have more beneficial to the debtor statute of limitations, burden of proof, and other important provisions;
4. No full faith and credit, comity or supremacy clause issues;
5. Favorable to the debtor spendthrift provision laws;
6. Confidentiality and privacy; and
7. Flexibility.

B. Protective Features of Foreign Trusts

Foreign trusts offer two major advantages to debtors. From a practical perspective, because the trustee is domiciled in a foreign nation, at some point in time the creditor would have to litigate its claim against the trustee and pursue a collection action in that foreign nation. That is a costly proposition for all creditors, particularly if the creditor is a plaintiff’s attorney who is not licensed to litigate in that foreign nation.

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From a legal perspective, several offshore jurisdictions have enacted trust laws that are particularly favorable to debtor-beneficiaries and debtor-settlors. Jurisdictions like the Cook Islands (in the South Pacific),[1] Saint Vincent and the Grenadines (in the West Indies),[2] and Nevis (in the West Indies)[3] are considered to be among the best currently available foreign trust jurisdictions. The trust laws in all three jurisdictions are almost identical, as both Saint Vincent and Nevis based their trust laws on the laws of the Cook Islands. Using Saint Vincent as an example (but all three jurisdictions have similar provisions), the following favorable asset protection provisions have been incorporated into that nation's trust laws: (i) there is no recognition of foreign judgments with respect to trusts;[4] (ii) there is a very short statute of limitations on fraudulent transfers;[5] (iii) to establish a fraudulent transfer the creditor must show that the debtor was insolvent,[6] and must establish the debtor's intent to "hinder, delay or defraud" beyond a reasonable doubt;[7] (iv) the anti-duress provisions are incorporated into the statutes;[8] and (v) spendthrift protection is extended to self-settled trusts.[9] These jurisdictions also offer the additional advantages of (a) not being subject to the U.S. constitutional issues like the Full Faith and Credit clause; (b) using the English common-law legal system; (c) having abolished the rule against perpetuities; and (d) not allowing trusts to be pierced for child or spousal support.

Not all offshore jurisdictions offer the same asset protection benefits as the three cited above. For example, Bahamas lacks clauses (i), (ii) and (iii). Bermuda and Cayman Islands lack clauses (i), (ii), (iii) and (v). Mauritius lacks clause (i).

Interestingly, New Zealand has been recently gaining popularity as an asset protection destination. New Zealand is closely tied to the Cook Islands (which were a former New Zealand protectorate) and its trust laws are at the forefront of other developed nations. New Zealand does not tax trusts that generate their income elsewhere, but it does recognize self-settled trusts. In eyes of some practitioners, New Zealand is not a "notorious" asset protection jurisdiction, and makes planning easier.

There are several disadvantages to using New Zealand for asset protection purposes. New Zealand has a relatively long statute of limitations on fraudulent transfers (four years), it will recognize a U. S. judgment, and there is no established history of protecting trust settlors and beneficiaries from creditors. (At least not to the same extent as in St. Vincent, the Cook Islands and Nevis.) Because foreign asset protection trusts should be used openly, and they are extremely effective if established in the right jurisdiction, perceptions by creditors (and even judges) are not very important.

The nonrecognition of foreign judgments is the most important protective feature of the offshore asset protection jurisdictions. Assume that a creditor obtains a judgment against a debtor in a California court and would like to enforce the judgment against the debtor's assets. The debtor's assets have been transferred into a Saint Vincent trust which in turn funded a Swiss bank account.[10]

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[1] Cook Islands International Trusts Act, 1984.
[2] Saint Vincent and the Grenadines International Trusts Act, 1996.
[3] Nevis International Exempt Trust Ordinance, 1994.
[4] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part X, § 39.
[5] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 46.
[6] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 45(1)(b).
[7] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 45(5).
[8] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part III, § 10(2).
[9] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part II § 9(7).
[10] Unlike most DAPT jurisdictions (see, *e.g.*, Alaska Statutes § 13.36.035(c)(1)), the foreign trust jurisdictions do not require that the trust hold any assets in the jurisdiction of its domicile. Consequently, a Saint Vincent or Cook Islands trust can hold assets located anywhere in the world.

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The creditor will be unable to domesticate its judgment in Saint Vincent, and will usually be unable to litigate its case *de novo* in Saint Vincent.[11] Consequently, the creditor's sole remedy would be to bring a fraudulent transfer action against the trustee of the foreign trust and attempt to show that the settlement of the trust by the debtor constituted a fraudulent transfer.

Given that the more favorable asset protection jurisdictions have a very short statute of limitation for fraudulent transfers,[12] require proof of intent beyond a reasonable doubt and require proof of debtor's insolvency, the creditor faces a daunting task.

C. Maximizing Protection of Foreign Trusts

1. Location of Assets

The nearly impregnable asset protection of a foreign trust may only be relied upon if the trust holds foreign assets. If the trust holds U.S. real estate, the jurisdiction over the real estate and the applicable choice of law forum will usually be the jurisdiction where the real estate is located (see above).

For personal property, including intangibles, the choice of law should be the domicile of the foreign trust (see above), but so long as a court in the U.S. has any jurisdiction over the assets, the protection cannot be assured. For example, if the debtor transfers share certificates of a publicly traded corporation to his foreign trust, the judge can disregard the trust or the laws of the foreign jurisdiction applicable to the trust and can then issue an order to the corporation's stock transfer agent to cancel the debtor's shares and issue new shares to the creditor.

The assets of a foreign trust need to be located offshore only when the creditor commences its collection actions against the debtor-settlor. Until such time when the settlor becomes a debtor, the trustee can hold trust assets in the U.S. For fraudulent transfer purposes, the relevant testing date is the settlement of the trust. Where the trust holds its assets, or what those assets are, is irrelevant in the fraudulent transfer analysis. However, because the assets may need to be moved offshore quickly, there is a strong preference for using foreign trusts to hold liquid assets.

2. Drafting Considerations

Foreign trusts are a commonly used asset protection device for two reasons: (i) a properly drafted trust should avoid most of the problems cited in the reported decisions (as discussed below), and (ii) a foreign trust may be the best available alternative for most debtors, even if "bulletproof" protection cannot be obtained.

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[11] The creditor will generally be unable to bring a lawsuit against the debtor in Saint Vincent because a Saint Vincent court would not have personal jurisdiction over the debtor. See, generally, *International Shoe Co. v. Washington* (1945) 326 U.S. 310, 316 (if the court does not have personal jurisdiction over the defendant, than minimum contacts must exist between the defendant and the jurisdiction). Additionally, Saint Vincent would not be the proper venue for a lawsuit, because a lawsuit can be brought in the jurisdiction where the debtor resides, where the cause of action arose, or where the contract was entered into. 15 U.S.C. § 1692i(a)(2)(A)-(B); Code of Civil Procedure § 395(a).

[12] For example, in Saint Vincent, the statute of limitations is two years from the date of the cause of action against the debtor-settlor, or one year from the settlement of the trust. Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 46(1).

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a. Trustee

A very important issue in establishing a foreign trust is the selection of the trustee for the trust. The foreign trustee selected should have no U. S. contacts, directly or indirectly, through affiliates, subsidiaries, agents or representatives. A trustee having any contacts with the U. S., whether directly or through agents, may risk having "minimum contacts"[13] with the U. S., thus becoming subject to the jurisdiction of a U. S. court.

Additionally, it is important to properly characterize trustee's powers in the trust. This is a common dilemma facing settlors. Settlors want to retain control over the trust assets and retain access to the assets, while sufficiently removing themselves from the trust so as not to have any control for the contempt analysis (see below).

This is usually accomplished by the use of a discretionary trust, wherein the trustee has full discretion in deciding when, to whom and how much to distribute from the trust. The discretionary trust is supplemented with a "letter of wishes" which is a non-binding expression of the settlor's intentions. The letter of wishes can advise the trustee on how the settlor would like the trustee to exercise its discretionary powers. Because the letter of wishes is merely a statement of settlor's intent and is not binding on the trustee, it is not treated adversely in the "contempt" analysis. The letter of wishes may be updated on an annual basis.

Settlor may also wish to appoint an independent third party as a trust advisor or a trust protector. The job of this independent (but friendly to the settlor) third party would be to assist the trustee in making decisions with respect to distributions from the trust, and other discretionary powers of the trustee.

Because a trust advisor or a trust protector may be viewed in the same capacity as a trustee, it is inadvisable to have such person in the U. S. unless the advisor's/'protector's powers are merely passive. If the powers are passive, meaning the advisor/protector can veto a trustee's decision or remove the trustee, but cannot force or advise the trustee to undertake an action, then such person may reside in the U. S. There would be no power that such advisor/protector possesses that may be used by a U. S. court to the detriment of the debtor.

In a more recent case,[14] the district court was asked by the Department of Justice to determine whether the settlor of a foreign trust, one Arline Grant, had to repatriate the money to pay down her tax liability. Arline Grant's husband was the settlor of two foreign trusts, one in Jersey and one in Bermuda and she became the sole beneficiary of both trusts on his death. The question before the court was whether Arline Grant was simply a beneficiary or did she possess any control over the trust to make her something more than a mere beneficiary. "Once the power of the person who is either the owner or the beneficiary of the asset to repatriate is established, the court can require that person to repatriate the funds."[15]

Both trusts granted Arline Grant the power to replace the trustee and appoint a new trustee, which could be located anywhere in the world. Her power was appoint a new trustee was absolute and not subject to approval by any other person. Once appointed, the trust would then be governed by the laws of the jurisdiction where the new trustee was located.

The court concluded that it had the power to force Arline Grant to replace the existing trustee with a U.S. trustee, and thus repatriate the funds. The court further concluded that as a practical matter, Arline Grant had the power to ask the existing trustee for a distribution of the trust corpus, and such distribution would not be denied. The court ordered Arline Grant to appoint new trustees for both trusts, each based on the United States, and alternatively, to repatriate the funds to the United States.

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[13] The minimum contacts test is the requisite threshold to establish nexus under the Due Process clause.
[14] U.S. v. Grant, 2005 U.S. Dist. LEXIS 22440 (S.D. Fl. 2005).
[15] *Id.*

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Like the Andersons, the Grants had a poorly drafted trust.

b. Contempt

Because California and other U.S. courts are unable to reach the foreign assets of a foreign trust, or exercise jurisdiction over the foreign trustee, the courts focus on the sole person that they can control – the settlor-debtor.

If a California court (that usually would have personal jurisdiction over a California resident debtor) orders the debtor to repatriate the assets of a foreign trust, the debtor may have to obey the court order or be held in contempt.

Contempt is generally defined as an act of disobedience to an order of a court, or an act of disrespect of a court.[16] There are two types of contempt: civil (intent is to coerce a party to do something) and criminal (intent is to punish a party for an action).[17] Both types of contempt involve the imposition of similar sanctions: payment of money, imprisonment, or both.[18] However, if the court orders a party to do something that is practically impossible, a civil contempt charge will not stand.[19]

In a foreign trust situation, the court usually attempts to coerce the debtor into repatriating the money, which is civil contempt.[20] The debtor, in turn, tries to establish that it is impossible for him to comply with the court order, and the contempt charge should not stand.[21] A number of cases have attempted this line of attack.

In the most notable case on point, *F.T.C. v. Affordable Media, LLC*,[22] the debtors, who allegedly engaged in a telemarketing fraud scheme, funded a Cook Islands trust and appointed themselves as the co-trustees and protectors of the trust, together with a Cook Islands trust company. When the court ordered the debtors to repatriate the assets of the trust, the debtors, acting as co-trustees of the trust, had sufficient control over the trust to repatriate the assets. The debtors, however, notified their Cook Islands co-trustee of the court order, and were promptly removed as a co-trustee. They were held in contempt of court, by the district court.

On appeal to the Ninth Circuit the debtors argued that it was impossible for them to comply with the repatriation order, because the Cook Islands trustee (by then the sole acting trustee) refused to repatriate the assets. The Ninth Circuit held that the debtors did not demonstrate that it was impossible for them to repatriate the money, and upheld the district court's contempt charge.[23] The court then analyzed whether the debtors retained sufficient control over the assets of the trust.

[16] *Black's Law Dictionary* 313 (7th ed. 1999).
[17] *Id.*
[18] In asset protection cases debtors usually have no money, and imprisonment becomes the sole available sanction.
[19] *U.S. v. Rylander* (1983) 460 U.S.752, 757 ("Where compliance is impossible, neither the moving party nor the court has any reason to proceed with the civil contempt action.")
[20] Criminal contempt has a high burden of proof, and usually requires a jury trial. It rarely applies to asset protection cases because criminal contempt cannot be used coercively – *i.e.*, the debtor will spend time in jail regardless of whether any money is retrieved from the trust.
[21] Even if compliance is impossible, contempt charges will stick if the impossibility is self-created. Impossibility will be deemed self-created if the foreign trust is funded in close proximity to the timing of the court's order. *In re Lawrence* (11th Cir. 2002) 279 F.3d 1294, 1300. In *Affordable Media* (see below), the impossibility arose after the court ordered the debtor to repatriate the funds.
[22] (9th Cir. 1999) 179 F.3d 1228 (colloquially referred to as the "Anderson" case).
[23] *Id.* at 1240.

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According to the court, the following facts were indicia of control: (i) no rational person would send millions of dollars overseas without retaining control over the money; (ii) the debtors previously withdrew $1 million from the trust to pay a tax liability; and (iii) they acted as a protector of the trust with the ability to remove the Cook Islands trustee and appoint a new trustee.[24]

These arguments appear valid, until one revisits the purpose of civil contempt, which is to coerce the debtor to repatriate the assets. All of the arguments made by the court establish that the debtors possibly did have sufficient control, at some point, to repatriate the money. However, once the debtors surrendered their control, there was no further purpose to the contempt charge.

The court's analysis was also faulty as follows: (i) rational people may give up control over their assets if the alternative is to lose the assets to a creditor; (ii) even though a debtor may surrender control over his assets, he will still be the beneficiary of the trust holding equitable interests in the assets of the trust; (iii) in *Affordable Media* the debtors withdrew money from the trust when they were co-trustees, but as soon as they were removed as co-trustees that control string was cut; and (iv) the fact that a trust may allow the beneficiary to petition for distribution when there is no collection action and removes that power when there is a collection action is simply good practice, it does not establish that control exists at all times.

In the few reported contempt cases, courts appear to be eager to find contempt.[25] One possible explanation is the Ninth Circuit statement in *Affordable Media* that foreign asset protection trusts operate by frustrating the jurisdiction of domestic courts.[26] The court's logic appears to be on very shaky ground. Any transfer to a foreign person or entity, where the debtor does not remain in control over the transferred assets will frustrate the jurisdiction of a domestic court. The debtor may gift all of his assets to a Mexican corporation, contribute his assets to a U.K. trust, or assign them to a Swiss GmbH. What frustrated the Ninth Circuit were not the debtor's actions or intentions, but the difference in the law among these jurisdictions. With the non-asset protection jurisdictions, a court's judgment may be enforceable in the foreign jurisdiction, the foreign jurisdiction may have more creditor-friendly fraudulent transfer, trust and collection statutes. The only real difference between a debtor funding an Alaska trust and a Cook Islands trust is in the applicable law (including the application of the federal constitutional law), not the debtor's actions.

The debtor's choice of law should not factor into the impossibility analysis. The only question is whether the debtor has retained control over the assets, so that it would not be impossible for the debtor to repatriate the assets (which was the Ninth Circuit's ultimate holding in *Affordable Media*). If there is no finding of control, impossibility exists, and contempt should not stand.

Consequently, a finding of contempt is solely a question of poor drafting. If the trust allows the settlor-debtor sufficient control over the trustee, then the courts are within their right in finding the debtor in contempt, as in *Affordable Media*. But if the debtor has completely surrendered control, contempt charges should not stand. Consequently, foreign trusts should be drafted as arm's-length irrevocable trusts, with spendthrift clauses, and as much discretion as possible conferred on the trustee. Debtors should never act as co-trustees or protectors, or retain any power to remove a trustee and appoint a new trustee.[27]

[24] *Id.* at 1242-1243.
[25] See, *e.g.*, *In re Lawrence*, (Bankr. S.D. Fla. 1999) 238 B.R. 498; *Eulich v. U.S.* (2006) 2006 U.S.Dist.LEXIS 2227.
[26] *Affordable Media* at 1232.
[27] The debtor's power to replace a trustee with a U.S. domiciled trustee caused repatriation of a foreign trust's assets in *U.S. v. Grant* (2005) 2005 U.S. Dist. LEXIS 22440.

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c. Best Available Alternative

Foreign trusts may not work a 100% of the time, they may be exposed to possible risks and challenges, but for many debtors a foreign trust may be the best available asset protection alternative.

There are approximately twenty reported cases piercing the protective benefits of foreign trusts, some are discussed above. Even assuming that these cases are not due to bad drafting or bad facts, they still represent an infinitesimally small percentage of all foreign trusts. According to a speech delivered by Jack Straw in 2002 (at the time, the British Foreign Secretary), it was estimated that approximately $6 trillion was held in "offshore" structures (and that number is probably higher today).[28] Based on the anecdotal evidence available to the author, approximately 10,000 trusts have been established in the aggregate in the Cook Islands, Nevis and Saint Vincent.

There is a simple reason why foreign trusts are extremely effective the vast majority of the time. Unless the creditor has the deep pockets of an agency of the U.S. government, or of a large bank, it is simply too expensive to pursue the assets of a foreign trust.

D. Tax Treatment

There are two tax implications of foreign asset protection trusts: tax treatment implications and reporting requirements.

1. Foreign v. Domestic for Tax Purposes

In the common nomenclature, the term "foreign trust" means a trust that is governed by the laws of a foreign country. For tax purposes, the term "foreign trust" is a term of art. Pursuant to Code Section 7701(a)(31)(B), a foreign trust is any trust other than a domestic trust. A domestic trust, pursuant to Code Section 7701(a)(30)(E), is a trust that meets both the "court test" and the "control test."

a. Court Test

To meet the court test, a court in the U. S. must be able to exercise primary supervision over the administration of the trust.[29]

The term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.[30] Administration includes maintaining books and records, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.[31] If both a U. S. court and a foreign court can exercise primary supervision then the trust will also satisfy the court test.[32]

[28] U.N. Human Rights Report 2002, Annex 1.
[29] Code Section 7701(a)(3)(E)(i).
[30] Treas. Reg. Section 301.7701-7(c)(3)(iv).
[31] Treas. Reg. Section 301.7701-7(c)(3)(v).
[32] Treas. Reg. Section 301.7701-7(C)(4)(i)(D).

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The regulations provide a safe harbor for the court test. Under the safe harbor, a trust will satisfy the court test if: (i) the trust instrument does not direct that the trust be administered outside the U. S.;[33] (ii) the trust is in fact administered exclusively in the U.S.; and (iii) the trust is not subject to an automatic migration provision.[34]

An automatic migration provision is any trust clause which provides that if a U. S. court attempts to assert jurisdiction or supervise the administration of the trust, the trust would no longer be administered in the U. S., but would now be administered and subject to the laws of a foreign country.[35]

Some practitioners have advocated drafting asset protection trusts that are governed by U.S. law, but giving power to a trustee or a third-party to change the governing law of the trust. Thus, the trust would have no automatic migration clause, but would still be able to migrate if the circumstances demanded so.

A trust drafted as a domestic trust without an automatic migration clause would certainly satisfy the safe harbor of the regulations. However, if a trustee or a third-party exercises the power to migrate the trust offshore, that may be deemed a fraudulent transfer, and the trustee or the third-party may be potentially liable for the fraudulent transfer.

b. Control Test

To meet the control test, one or more U. S. persons must have the authority to control all substantial decisions of the trust.[36]

A U. S. person is defined in Code Section 7701(a)(30) as a citizen or resident of the U.S., or a partnership or corporation organized in the U. S. "Substantial decisions" means those decisions that are not ministerial.[37]

The control test basically requires an appointment of a U. S. trustee or trust protector.

If the trust originally appointed a U. S. trustee and the trustee was later inadvertently substituted with a foreign trustee (which causes the trust to become a foreign trust), the trust is allowed 12 months to rectify that problem by replacing the foreign trustee with a U. S. trustee.[38]

2. Tax Treatment of Foreign Trusts

Pursuant to Code Section 684, a transfer of property to a trust treated as a foreign trust for tax purposes is deemed to be a sale of assets to the foreign trust for fair market value. This causes the settlor of the trust to recognize gain. Additionally, if a domestic trust is recharacterized as a foreign trust, the domestic trust is treated as selling its assets to the foreign trust.

[33] For the purposes of the test, territories and possessions are not counted as U. S.
[34] Treas. Reg. Section 301.7701-7(c)(1).
[35] Treas. Reg. Section 301.7701-7(c)(4)(ii).
[36] Code Section 7701(a)(30)(E)(ii).
[37] Treas. Reg. Section 301.7701-7(d)(ii). Ministerial decisions include: bookkeeping, collection of rent and making investment decisions.
[38] Treas. Reg. Section 301.7701-7(d)(2).

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The only time there will be no gain recognition on the settlement of a foreign trust is when the foreign trust is treated as a grantor trust under the rules of Code Section 671.

In addition to direct transfers of assets to a foreign trust, certain indirect or constructive transfers will trigger gain recognition.

a. Indirect Transfers

Indirect transfers are present when the assets are transferred to the foreign trust through an intermediary. The transfer of property must be made pursuant to a plan "one of the principal purposes of which is the avoidance of U. S. tax."[39]

Tax avoidance will be deemed to be the principal purpose if (i) the U. S. person is related to the beneficiary of the foreign trust, and (ii) the following conditions are not present:

1. The intermediary has a relationship with a beneficiary of the trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust;
2. The intermediary acted independently of the U. S. person;
3. The intermediary is not an agent of the U.S. person under generally applicable United States agency principles;[40] and
4. The intermediary must have timely complied with the reporting requirements of Code Section 6048.[41]

The four conditions establish the existence of an arm's-length relationship between the settlor and the intermediary.

If there is a transfer to a foreign trust through an intermediary and one of the principal purposes is tax avoidance, then the existence of the intermediary is disregarded, and the settlor is treated as making a direct, taxable transfer to the foreign trust.[42] The settlor will be taxed on the transfer when the settlor transfers the property to the intermediary, not when the intermediary transfers the property to the trust.

b. Constructive Transfers

The term "constructive transfer" is defined in the regulations as "any assumption or satisfaction of a foreign trust's obligation to a third party."[43] Additionally, a guarantee of a trust's obligation may be deemed as a transfer to the trust.[44]

The tax effect of the assumption of debt or the guarantee of a liability is taxation of the settlor on the amount deemed transferred.

Additionally, a transfer of property to a foreign entity owned by a foreign trust will be treated as a transfer by the settlor to the foreign trust, followed by a contribution by the trust to the foreign entity.[45]

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[39] Treas. Reg. Section 1.679-3(c)(1).
[40] The principle test for agency is control.
[41] Treas. Reg. Section 1.679-3(c)(2).
[42] Treas. Reg. Sections 1.679-3(c)(1) and (3).
[43] Treas. Reg. Section 1.679-3(d).
[44] Treas. Reg. Section 1.679-3(e).
[45] Treas. Reg. Section 1.679-3(f).

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3. Grantor Trust Rules

a. Classification as a Grantor Trust

The classification of an offshore asset protection trust as a foreign trust is prohibitive from a tax standpoint. Yet, all offshore asset protection trusts are foreign trusts for tax purposes. The sole purpose of an offshore asset protection trust is to change the applicable law to a foreign country, and to empower a foreign trustee to administer the trust. Obviously, that has the effect of failing both the court and the control test, and both are needed to classify a trust as domestic.

However, even if a trust is classified as a foreign trust, and Code Section 684 taxes transfers to foreign trusts, there is an exception carved out for foreign trusts that are grantor trusts within the meaning of Code Sections 671-679.[46]

Under the grantor trust rules, a trust will be treated as a grantor trust if the grantor (the settlor) retains a reversionary interest in the trust, has power to control beneficial enjoyment, has power to revoke the trust, may receive income distributions from the trust, or if the trust is foreign and has a U. S. beneficiary.

Generally, most of these conditions will apply to a foreign asset protection trust. However, the last clause, which is contained in Code Section 679 is present in virtually every foreign asset protection trust.

Pursuant to Code Section 679, a foreign trust will be treated as a grantor trust if (i) there is a transfer of property to the trust, at a time when (ii) the trust has a U. S. beneficiary. A U. S. beneficiary is defined as a U. S. person who is or may be a beneficiary of the trust. Thus, even a contingent future U. S. beneficiary of a fully discretionary trust will be treated as a U. S. beneficiary. Even if the trust presently does not provide for any possibility of having a U. S. beneficiary, if the trust may be amended in the future to include a U. S. beneficiary, the trust will be treated as having a U. S. beneficiary.

However, if the interest of a potential beneficiary is remote, that beneficiary will be disregarded. A beneficiary's interest is remote when the likelihood of that person becoming an actual beneficiary is negligible. For example, the regulations give an example of a first cousin who may become a beneficiary under the laws of intestate succession, but the possibility of that happening is so remote that the first cousin is disregarded as a beneficiary.[47] The remote interest exception does not apply to the trustee's discretion. This means that so long as the trustee has discretion to select a U.S. beneficiary, the trust will be treated as having a U. S. beneficiary.

In determining the existence of a U. S. beneficiary, attribution rules are applied to corporations and partnerships.

If the trust has a U.S. beneficiary, the transferor is taxed not only on income of the trust during the year, but on all undistributed net income of the trust since it was created.[48]

b. Tax Treatment of Grantor Trusts

The bright side of treating a foreign asset protection trust as a grantor trust under Code Section 679 is the fact that Code Section 684 does not apply. Which means that grantors are free to settle trusts with appreciated property without gain recognition. Treatment as a grantor trust also ensures that the transfer of assets to the trust

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[46] Code Section 684(b).
[47] Treas. Reg. Section 1.679-2(a)(2)(iii), Ex. 7.
[48] Code Section 679(b).

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is not subject to the gift tax (which is usually the primary consideration, as foreign trusts are usually settled with cash and not appreciated assets).

However, if the trust is treated as a grantor trust, that also means that pursuant to Code Section 671, the grantor (settlor) of the trust is taxed on all trust income (settlor of the foreign trust continues to report trust's income on her 1040). This is the reason why foreign asset protection trusts are always tax neutral. They are always treated as grantor trusts under Code Section 679, and thus do not allow the settlor to escape taxation.

4. Reporting Requirements

a. On Transfer of Assets to the Trust

As a general rule, transfers to foreign trusts have to be reported to the Service.[49] The reporting requirements were revised substantially in 1997, with the issuance of Notice 97-34.[50] Under the Notice, transfers fall into two categories: gratuitous and nongratuitous.[51]

With certain exceptions, gratuitous transfers to foreign trusts have to be reported to the Service on Form 3520. For these purposes, a transfer is gratuitous if it is made for less than full consideration (the transfer does not need to constitute a gift for tax purposes).

Nongratuitous transfers must also be reported to the Service on Form 3520 if no gain is recognized at the time of the transfer of appreciated property, or the transferor is related to the trust.[52]

An exception to the Form 3520 requirement is a fair market value sale to the trust (a "transfer for value"). A transfer for value "includes only transfers in consideration for property received from the trust, services rendered by the trust, or the right to use property of the trust."[53] A transfer of property to a trust in exchange for an interest in the trust does not constitute a transfer for value.

Additionally, most obligations received by a settlor who transfers money or other property to a "related" trust will not constitute a transfer for value and will be subject to the Form 3520 reporting requirements.[54] There is an exception for "qualified obligations" which will constitute fair market value.

To constitute a qualified obligation, it must meet certain conditions, such as having a term of not less than five years and bearing interest at a rate between 100 percent and 130 percent of the applicable federal rate. To be a qualified obligation, the obligation must be reported to the Service on Form 3520.

Accordingly, it is not possible to avoid the reporting requirement by using obligations. If the obligations are not qualified, then the transfer is gratuitous and Form 3520 must be filed. To make the transfer nongratuitous, the obligation must be qualified by reporting it to the Service on Form 3520.

[49] Code Section 6048(a).
[50] 1997-1 C.B. 422.
[51] Notice 97-34, Section III.
[52] Notice 97-34, Section III, D. In this context, a person related to the trust will include the settlor, a beneficiary, or a person related to the settlor or beneficiary.
[53] Notice 97-34.
[54] Code Section 6048(a)(3)(B)(i); Notice 97-34, Section III, C.1.

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b. Annually

A return for the foreign trust is required to be filed by the trustee (or agent who is authorized to sign) on Form 3520-A. Copies must then be provided to the grantor and the beneficiaries. However, while the trustee is required to file the return, the obligation to ensure the filing falls on the owner of the trust.[55]

c. Agent

Generally, the trust will appoint a U. S. agent for the limited purpose of accepting service of process with regard to witnesses and books and records pursuant to Code Sections 7602, 7603 and 7604. The U.S. agent "shall not subject such persons or records to legal process for any purpose other than determining the correct" income tax treatment of trust income. Further, the foreign trust that appoints the agent will not be considered to have an office or permanent establishment in the United States or to be engaged in a U.S. trade or business solely because of the agent's activities.[56]

The effect of these rules is to allow the IRS access to the information required for determining tax liability in all events and regardless of the secrecy laws of foreign countries. When a U.S. agent is not appointed, the IRS is authorized to determine the amount of income to be taken into account under the grantor trust rules.

See Notice 97-34, Section IV.B. for form of agent appointment.

d. Reporting by Beneficiaries

A beneficiary of the trust must file Form 3520 if he is a U. S. person and receives (directly or indirectly) any distribution from the foreign trust during the taxable year.[57]

The reporting requirement applies only if the U.S. person has reason to know that the trust is a foreign trust. The information required includes the name of the trust, the aggregate amount of the distribution received during the year, and such other information that the IRS prescribes. In determining whether the U.S. person receives a distribution from or makes a transfer to a foreign trust, the fact that a portion of the trust is treated as owned by another person under the grantor trust rules is disregarded.

e. Penalties

The penalty for failure to file Form 3520 is 35% of the "gross reportable amount."[58] An additional $10,000 penalty is imposed for a continued failure for each 30-day period, or a fraction thereof, beginning 90 days after the IRS notifies the responsible party of the failure. The total amount of the penalties, however, is limited to the gross reportable amount.

If a portion of the transaction is reported, then the penalty will be imposed only on the unreported amount.

[55] Code Section 6048(b)(1).
[56] Code Section 6048(b)(2)(B).
[57] Code Section 6048(c).
[58] Code Sections 6677 and 6039F(c). There is a "reasonable cause" and "not willful neglect" defense available for this penalty.

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An additional 5% penalty is imposed on the failure to comply with the annual reporting requirement.[59]

[59] Code Section 6677(b).

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