Asset Protection for Physicians and High-Risk Business Owners

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CHAPTER NINE

Asset Protection Trust

A variety of sophisticated features can be added to the strategies we have discussed by taking advantage of laws designed to encourage asset protection and privacy goals. In this chapter, we will discuss a popular planning option known as the Asset Protection Trust and show you the opportunities for enhancing the structure of your overall plan.

The Asset Protection Trust

A popular and successful strategy for protecting privacy and assets is known as the Asset Protection Trust (APT). A recent report by the U.S. Department of the Treasury stated that in response to concerns about litigation the market for APTs is "exploding." The Treasury Department estimates that assets worth "tens of billions of dollars" are currently in these types of trusts with the number and amount growing rapidly each year. An article in the January 1996 *American Bar Association Journal* stated, ironically, that lawyers are seeking protection from the hazards of their profession by setting up APTs for themselves. As one attorney quoted in the article put it, *"I don't want someone doing to me what I do to them all day in court."*

The reason for the popularity of this technique is that it acts as an ultimate safety valve—providing an additional layer of protection for plans designed to avoid frivolous "deep pocket" litigation. Many individuals, wary of the potential for abusive lawsuits and frustrated by widespread violations of personal privacy, view the APT as an important component of a sound financial plan.

Features of the APT

In many ways an Asset Protection Trust looks like a standard domestic trust. The settlor is the person who transfers the assets to the trust. The trustee is generally a trust company, whose business is operated outside of the United States. The arrangement differs from Privacy Trust–Plan #1 and Privacy Trust–Plan #2 because, in this case, the trust company is located in a foreign country—outside the jurisdiction of U.S. courts. The Asset Protection Trust takes advantage of favorable asset protection and privacy laws which exist in other parts of the world.

In a typical trust, the trustees are given discretion to accumulate or distribute income among a specified class of beneficiaries. The settlor may be one of the named beneficiaries, together with his spouse, children, or grandchildren. One unique feature of this kind of a trust is the role of the *Protector*. The Protector is a person, designated by the settlor, whose consent is necessary for certain activity by the trustees. The term of the trust may be limited to a period of years, or it may continue after the settlor's death.

Moving Property Overseas

One way to use an APT is to transfer cash, securities, or other liquid assets to an account established under the name of the trust at a bank of your choice in a foreign jurisdiction. The Protector then advises the trustees on the manner in which the funds are to be held or invested. Income can be distributed to the beneficiaries or accumulated in the trust.

This arrangement, as shown in figure 9-1, provides excellent privacy and asset protection. As we will discuss, assets held in an overseas trust account—in a country with strict bank secrecy laws—can be a legitimate and powerful legal strategy for sophisticated individuals who are willing to tolerate some degree of inconvenience and additional expense in order to achieve a particular result.

Keeping Property in the U.S.

Most of our clients want the option to transfer funds into an overseas account—but are reluctant to do so immediately. The solution is to use a domestic entity such as a Family Limited Partnership or Limited Liability Company to maintain property in the United States. This popular strategy is illustrated in figure 9-2.

Under this arrangement, husband and wife are the general partners or members with complete management and control over the company. Only the membership or partnership interests are transferred to the APT. The strategy is similar to Privacy Trust–Plan #2—but the trust uses a foreign rather than a domestic trust company.

The trustee has no right to interfere in the management of the assets of the partnership or the LLC. Control is maintained by husband and wife as general partners or managers. Even though the trust holds the ownership interests, all of the assets remain physically located in the United States under the direct control and supervision of husband and wife.

This arrangement can provide a high level of asset protection benefits. Property is legally insulated within the FLP or LLC. The Asset Protection Trust owns and protects the *interests* in those entities. Liquid assets can be moved into the overseas trust account for additional protection or investment purposes.

Advantages of the Asset Protection Trust

The Asset Protection Trust is a trust established under the laws of a country which are more favorable to asset protection and privacy objectives than the laws in the United States. For example, the laws in some countries provide for a statute of limitations on fraudulent conveyances which can be as short as one year and the standard of proof required for a fraudulent conveyance is the difficult "beyond a reasonable doubt" rather than the lesser civil standard of a "preponderance of the evidence." The courts in these countries will not enforce a judgment rendered in the United States, or an order of a U.S. Bankruptcy Court. To prosecute a claim against the trust, the creditor would have to go to that country and retry the underlying case, an almost impossible requirement.

A further advantage of the Asset Protection Trust is that a greater degree of flexibility can be achieved in the way in which the trust is established. The settlor of the trust can serve as beneficiary, and the trust will still be valid under local law. This allows the settlor to retain a substantially greater degree of enjoyment over trust assets than would be permitted under U.S. law with a domestic trust.

Of equal importance, an Asset Protection Trust allows a great deal of practical flexibility because the option is always available to move the assets into an account established in the foreign jurisdiction—subject to the protective features of local law. To reach those funds, the creditor would have to commence an action in the foreign jurisdiction and would have to overcome significant obstacles under the law of that jurisdiction.

The problem for a creditor with a judgment is that a U.S. court has no capacity to exercise its authority over a foreign trustee. Simply stated, a foreign person or company with no presence or assets in the United States cannot be compelled to act by a U.S. court. If a U.S. court ordered a foreign trustee to return assets, the foreign trustee, under a duty to preserve trust property, would refuse to comply with the order.

If a foreign person or entity has assets in the United States, a court can exercise leverage by threatening or attempting to seize those assets for failure to comply with the order of the court. For example, on occasion the U.S. Government seeks information about foreign bank deposits in matters concerning criminal tax evasion, drug charges, or securities law violations. Because of its local secrecy laws, the foreign bank usually fails to comply with the government's request for information. However, when the foreign bank has assets, such as deposits or branches in the United States, the government may threaten to seize the assets if the bank does not comply with the court order. Generally, this threat is successful and the bank will reveal the sought-after information.

Precisely for this reason, most foreign based trust companies do not conduct business or have assets in the United States. Any foreign trustee which is selected must have no local business activity in order to avoid the financial leverage which might then be applied by a U.S. court.

Since the creditor cannot obtain satisfaction by obtaining a U.S. court order against a foreign trustee, the only method for compelling the trustee to act is to file a lawsuit in the jurisdiction in which the trustee is located. Whether or not the creditor can be successful in this forum will depend upon the particular laws in effect in that country.

Contempt Orders Against U.S. Debtor

Can you, a U.S. resident and a settlor of the Asset Protection Trust, be ordered by a court to return assets transferred to the offshore account? A judgment creditor would certainly like to obtain such an order from the local court and whether he can do so depends upon the terms of the trust.

Clearly, if you have the right to retrieve the assets, a judge will order you to do so. Judges back up these orders with the power to hold a person in *contempt of court* for refusing to comply. The sole issue then is your legal ability to return transferred property pursuant to a court order.

This issue is resolved, in a properly drafted trust, by not giving the settlor any such power to revoke the trust or reacquire the assets without the consent of the trustee. Although the trustee typically will comply with the wishes of the settlor, the trust agreement requires the trustee to disregard any communications issued by the settlor under *duress*. That is, if the settlor is ordered by a court to communicate with the trustee, the trustee is required by the terms of the trust to ignore such requests for action.

As a result of this structure, the settlor has no legal right to revoke the trust and reacquire trust assets. A court cannot logically compel an action that an individual has no power to perform, and the foreign trustee will not respond to orders from a court outside of its jurisdiction. The conclusion is that the assets of the trust are protected, and the settlor should not be in contempt for failing to achieve a return of the property.

The result may be different when the Asset Protection Trust is used as a scheme to defraud creditors or the IRS, or to protect the proceeds of criminal or fraudulent activities. In these cases, where the defendant is perceived as a "bad guy," the judge may ignore the provisions of the trust document and apply the leverage of a civil contempt order. (See *FTC v. Affordable Media, LLC*.) The APT is not designed to allow individuals to defraud others or engage in tax evasion or criminal conduct. If the trust is used for an illegitimate purpose, significant legal pressure—including contempt sanctions—may be brought to bear on the offender.

Where to Create the Asset Protection Trust

Selecting the proper jurisdiction for the Asset Protection Trust is a matter of critical importance. As a general rule, the jurisdiction should have a well-established trust law favorable to asset protection strategies. Further, it should be inconvenient or nearly impossible for a U. S. creditor to reach the assets of the trust by commencing an action in the foreign country.

Key Factors

Consider the following factors when selecting a jurisdiction for an APT:

Ease of Communications

Communication with the foreign trustee must be convenient. Fortunately, the use of e-mail and fax as well as improvements in telephone technology have made communication with even the most geographically remote locations a relatively simple procedure. Using only English speaking countries avoids language barriers which can cause delays or costly mistakes.

Experienced and Well-Established Trustees

The country where the trust is established must provide a choice of responsible and experienced trust companies from which to select a trustee. The trust companies must be experienced in the area of asset protection and understand the nature of their peculiar responsibilities.

No or Low Tax Jurisdiction

Income earned by the Asset Protection Trust must not be subject to taxation in that jurisdiction.

Strict Bank Secrecy Laws

The country must prohibit disclosure of customer information by local trust companies and financial institutions.

Favorable Trust Laws

Many foreign jurisdictions do not recognize the existence of trusts or severely restrict these arrangements. It is important that the law of the country allows the greatest degree of flexibility in establishing the trust to meet privacy and asset protection objectives.

Stable Local Government

Political and economic stability is essential to the proper functioning of the trust. A country which may have its legal system or its financial institutions disrupted by unexpected forces should not be chosen.

Favorable Asset Protection Laws

The existence of laws designed to encourage the formation of trusts used for asset protection strategies is an essential factor. If a creditor elects to file a lawsuit in the foreign jurisdiction seeking to set aside the trust, the laws of that country must make it impractical for the creditor to obtain a successful result. A country which has no treaties with the U.S. and does not enforce foreign judgments is critical to the success of the plan.

Absence of Exchange or Currency Controls

The ability to move funds, if necessary, in and out of the jurisdiction without interference or restriction by local authorities is a requirement in selecting a location.

Confidentiality

The country which is chosen must allow for complete confidentiality of information concerning the settlor and the beneficiaries of the trust.

The Most Favorable Laws

Countries that have some or all of the features mentioned above include the Bahamas, Bermuda, the Cayman Islands, the Cook Islands, and Gibraltar.

The Bahamas

The Bahamas is one of the oldest and most established financial centers in the world. It has strict bank secrecy laws, no income tax, and a modern and sophisticated telecommunications structure. The location in the Caribbean is convenient to the United States. There are a number of excellent trust companies located in the Bahamas, and local law allows a satisfactory degree of flexibility in the creation of Asset Protection Trusts.

Bermuda

Bermuda is a group of English speaking islands located in the western Atlantic Ocean approximately 800 miles from New York City. Bermuda has a well-developed modern trust law. The country has no income tax or other form of taxation for profits or capital gains. Some professional advisers have complained that the Bermuda trust companies are difficult to work with, but it is hard to say whether these are isolated incidents or whether it represents a pattern of conduct sufficient to cause one to avoid Bermuda for these types of purposes.

The Cayman Islands

The Cayman Islands are a group of three islands conveniently located just one hour's flight from Miami. The main island is Grand Cayman, which has developed into a major offshore financial center. The population is small and homogeneous and enjoys a high standard of living. The islands also enjoy an exceptional degree of political and economic stability. The trust law of the Cayman Islands provides excellent asset protection features, and numerous trust companies are experienced and well-established. The Cayman Islands have strict bank secrecy provisions and no local income taxes. The islands are one of the most popular places for establishing Asset Protection Trusts.

The Cook Islands

The Cook Islands was the first jurisdiction to enact legislation encouraging the formation of Asset Protection Trusts. All trust companies are licensed and regulated by the government of the Cook Islands with the strictest qualification and capitalization standards.

The Cook Islands is located in the South Pacific near Tahiti and Samoa. Until 1965, the country was a protectorate of New Zealand and is now self-governed with its own legislature and prime minister. Communication facilities are excellent with modern international telephone, telex, and facsimile services via satellite. The Cook Islands are in the same time zone as Hawaii—two hours behind Pacific Standard Time and five hours behind Eastern Standard Time.

Since the enactment of the International Trusts Amendment Act of 1989, the Cook Islands have been the jurisdiction of choice for the creation of Asset Protection Trusts. The law provides the highest degree of protection, flexibility, and privacy. The trust companies in the Cook Islands are experienced and knowledgeable with an unblemished record of competency, thoroughness, and integrity unmatched by any other country in the world.

Gibraltar

Gibraltar is a British territory located off the coast of Spain at the western entrance to the Mediterranean. It is well-known as a convenient international offshore haven and has many local professionals and trust companies of high quality and reputation. Foreign trusts are not subject to any taxes in Gibraltar. The trust laws contain some favorable asset protection features. Asset Protection Trusts established in Gibraltar by Amendments to the Bankruptcy Ordinance are registered with the local government. Although access to this special register is limited to the local government, some practitioners are concerned that confidentiality may be impaired by this requirement.

Using the APT to Avoid Taxes

It is difficult to imagine an issue that is so clear yet produces as much confusion as the proper U.S. tax treatment of the Asset Protection Trust. Despite thousands of Web sites on the Internet promoting offshore trusts as legitimate strategies for avoiding income taxes—this is not the case. The APT does not provide any income tax advantage. *All of the income of the trust is included on the tax return of the U.S. settlor of the trust.* The trust is treated in the same manner as a revocable living trust. This rule applies whether the assets of the trust are located in the U.S. or in an overseas account. It also applies regardless of whether the source of the income is from the U.S. or from another country. All income of the trust is taxable on the return of the settlor in the year it is earned. It doesn't matter when the funds are distributed or returned to the U.S. *There is no strategy or technique which will alter this result without causing you to commit perjury or tax fraud*.

This treatment is beneficial from an asset protection standpoint because it allows you to transfer property to and from an APT without creating any tax consequences. No gain or loss is recognized, and no taxable income is produced by a contribution or distribution.

Summary

You can take advantage of favorable laws in other countries to enhance the asset protection features of any plan.

One technique is to deposit funds in an overseas account in the name of an Asset Protection Trust. Investments are managed by the trust company with advice and direction from the Protector. This strategy can create excellent financial privacy and asset protection when the overseas account is located in a country with strict bank secrecy and confidentiality laws.

Individuals who do not wish to transfer property overseas—until it is necessary to do so—prefer to use the Asset Protection Trust as a safety valve. Property and liquid assets are held in domestic entities such as an LLC or FLP. At a later point, if additional protection is required, assets can be transferred to the overseas trust account to be held according to the terms of the trust agreement.

The Asset Protection Trust cannot be used to avoid taxes or to "hide" the proceeds of illegal or fraudulent activities. Properly structured, the APT can be a powerful weapon to discourage frivolous lawsuits targeting "Deep Pocket" defendants and to protect against unforeseen liabilities arising out of a business or professional practice.
