
CHAPTER 4

Selected Drafting Issues with Asset Protection Trusts

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Introduction

The drafting of a trust agreement, involving as it does an intricate tripartite legal relationship between (1) one or more settlors, (2) one or more trustees, and (3) one or more beneficiaries, perhaps with varying degrees of interest in the trust fund, is often one of the most involved tasks devolving upon an attorney-draftsperson. Consider, for example, that in order to draft even the most basic trust agreement, the attorney-draftsperson must be familiar not only with the law of trusts, but also with the real and personal property laws of the jurisdiction in which the trust is to be established. In addition, the attorney-draftsperson (hereinafter “drafter”) must be well versed in the complexities of both state and federal income, gift, estate, and generation-skipping transfer tax law to ensure that the trust will achieve its intended purposes without undue adverse tax consequences.¹ Finally, with the repeal in recent years in many jurisdictions of the application of the rule against perpetuities to trusts, many trusts must now be drafted so that they are appropriate for not only the foreseeable future, but (in many cases) for uncountable future generations as well.

The type of trust with which we are primarily concerned here, the so-called “asset protection” trust, is perhaps the most difficult type of trust agreement to draft. This is because the asset protection element introduces into the drafting equation a number of additional factors that the drafter must duly consider. For example, the drafter needs to think about the application of fraudulent conveyance law, bankruptcy

law, banking law, and certain aspects of the criminal law. Moreover, in most cases the drafter must also consider the conflict of law rules applicable to both the jurisdiction that would serve as the likely forum for any future litigation against the trust, as well as the conflict of law rules applicable to the jurisdiction whose law is designated under the trust agreement as the trust's governing law. Finally, if the trust to be drafted is to be an "offshore" or "foreign" asset protection trust,² all of these areas of concern are multiplied by a factor of two or more since the drafter must then consider and plan not only for local law considerations, but for foreign law considerations as well.

A number of the drafting issues applicable to asset protection trusts are, for various reasons, particularly notable and warrant an in-depth analysis. They include, but are certainly not limited to, (1) drafting for a so-called "hybrid" foreign trust (defined below) for United States tax purposes, (2) drafting for the possibility of duress being exerted against the trust settlor, trust protector³ or trustee, and (3) drafting in consideration of United States gift, estate, and generation-skipping transfer taxation. This chapter will explore each of these drafting issues in detail and, where appropriate, will provide suggested drafting language for the drafter's consideration.

Drafting for a So-called "Hybrid" Foreign Trust

Introduction

For all of the asset protection benefits conferred by offshore asset protection trusts that are not conferred in equal measure by their newer domestic counterparts⁴ (a comparison of which is beyond the scope of this chapter), one negative side effect of the "foreign" status of such trusts is the administrative burden imposed by the additional tax reporting required of such trusts, as well as those who transact with, or are the beneficiaries of, such trusts.⁵ Some believe that the administrative burden of such tax reporting (which at present would require, at a minimum, the annual filing of a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, a Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and a Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner (Under section 6048(b))*, and potentially a Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*⁶) to be unduly onerous. Others might have the additional concern that the settlement of a foreign trust (or, alternatively, the holding of a beneficial interest in a

foreign trust) would heighten their visibility before the Internal Revenue Service and subject them to additional risk of audit. Finally, there is also the potential for the imposition of a substantial capital gains tax pursuant to Internal Revenue Code (IRC) section 684 where the foreign asset protection trust is structured so that the trust would not be includible in the taxable estate. For some individuals, these issues would compel a decision against establishing a foreign asset protection trust, irrespective of the individual's perceived creditor risk.

It is, therefore, extremely fortuitous that under the Internal Revenue Code a "foreign" asset protection trust (or any other trust, for that matter) is not necessarily a "foreign trust" for United States federal tax purposes. In point of fact, if it is deemed desirable to do so, an otherwise "foreign" asset protection trust can, through careful drafting, be qualified as a "United States person" and, as a consequence, be deemed a purely "domestic trust" for United States federal tax purposes, thereby eliminating all of the additional tax reporting requirements noted above except that a Form 1041, *U.S. Income Tax Return for Estates and Trusts*, would be required in lieu of a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*. Therefore, a "foreign" asset protection trust should actually be thought of simply as a trust whose designated governing law is, for trust law purposes, the law of some non-U.S. jurisdiction; more specifically, the taxonomy of a trust as a "foreign" asset protection trust should engender no necessary inference that the trust is also a "foreign trust" for United States federal tax purposes.

Definitions

An "offshore" or "foreign" asset protection trust that is drafted so as to qualify as a "United States person" (and, as a consequence, a "domestic trust" for United States federal tax purposes) is commonly referred to as a "hybrid" foreign trust. In order to understand how a hybrid foreign trust is drafted, however, it is first necessary to understand what exactly is a "domestic trust" (which term the Treasury Regulations state means a trust that is a "United States person")⁷ and what exactly is a "foreign trust" for purposes of the United States federal tax law. In this regard, we are referred to IRC sections 7701(a)(30) and (31), which respectively provide definitions of the mutually exclusive terms "United States person"⁸ and "foreign trust."⁹

As the term “United States person” relates to trusts, it is defined under IRC section 7701(a)(30)(E) as “any 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.”¹⁰ These two prongs are respectively referred to in the Treasury Regulations as the “court test”¹¹ and the “control test,”¹²

The term “foreign trust” is defined under IRC section 7701(a)(30)(E) in the Internal Revenue Code’s inimical way as “. . . any trust other than a trust described in subparagraph (E) of paragraph (30).” Stated plainly, all trusts are foreign trusts except those that meet both the court test and the control test.

The “Court Test”

The court test of IRC section 7701(a)(30)(E)(i) will be met if the trust is under the “primary supervision” of a United States court.¹³ This means that a United States court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.¹⁴ As the Treasury Regulations point out, however, this does not necessarily mean that another court does not have jurisdiction over a trustee, a beneficiary, or some property of the trust.¹⁵ Moreover, a trust would still be found in compliance with the court test even if both a United States court and a foreign court are able to exercise concurrent primary supervision over the administration of the trust.¹⁶

The phrase “is able to exercise” as used within IRC section 7701(a)(30)(E)(i) means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust.¹⁷ The term “administration” means the carrying out of the duties imposed by the terms of the trust deed and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending suits by creditors, and determining the amount and timing of distributions.¹⁸

Notably, since the court test looks only to the administration of a trust and not to the designated governing law of the trust, an asset protection trust can be drafted for compliance with the court test for determining whether the trust is a “United States person” for United States federal tax purposes notwithstanding the fact that the trust agreement provides for governance of the trust under foreign law. In order to provide for governance of the trust under the law of some appropri-

ate foreign jurisdiction (in the example below, the Cook Islands), with administration reserved to the courts of the United States or a political subdivision thereof (so as to ensure compliance with the court test), the drafter might consider using the following language:

The Applicable Law (as defined in Paragraph _____ of ARTICLE _____) of the Trust shall be the law of the Cook Islands. Notwithstanding the foregoing, however, as it is the intent of the Settlor that the Trust not constitute a “foreign trust” as defined in Section 7701(a)(31)(B) of the Code: (i) the place of administration of the Trust shall be the state of residence or domicile of the first such Trustee listed on Schedule I hereto,¹⁹ provided that in the event such person no longer serves as a Trustee, the place of administration shall be the state of residence or domicile of the longest serving Trustee resident or domiciled in the same country as a majority of the Beneficiaries; and (ii) with respect to all matters of administration of the Trust, but only as to matters of administration, the Applicable Law of the Trust shall be the laws of the place of administration. As such, primary supervision of administration shall be in the courts of the place of administration. Notwithstanding the foregoing, however, to the extent that the laws regarding administration of trusts in such place of administration conflict with the International Trusts Act 1984, as amended from time to time of the Cook Islands (the “Act”) as it may exist regarding the administration of trusts, the Act shall override and govern; and in such case, the courts of such place of administration shall apply the Act in the supervision of the administration of the Trust. In furtherance of the foregoing, it is the intent and purpose of the Settlor that the Trust satisfy and meet the definition of a “United States person” as that term is used within Section 7701(a)(30)(E) of the Code. In furtherance of this intent and purpose, no powers of the Trustees may be exercised and no provision hereof shall operate in any manner so as to cause the Trust to fail to so qualify as a United States person, and to such extent the respective powers of the Trustees as set forth throughout the Trust are hereby limited. Further, with respect to future regulations, rulings or court decisions which may affect the

evolving definition of a United States person as it applies to a trust, the Trustees are directed to manage and administer the Trust Fund in such a manner as to assure continuing compliance. If meeting the definition aforesaid shall require the Trustees to sign an agreement, make an election or use their powers to amend the Trust, they shall do so without liability. The foregoing provisions of this ARTICLE are subject always to the Trustees' power to remove a co-trustee resident or domiciled in a jurisdiction in which the Trustee has become subject to the threat of or the actual compulsion of the Trustee to sell, transfer or otherwise dispose of Trust Fund assets in a manner inconsistent with the terms and provisions of this Settlement and subject always to the Trustees' power to change the Applicable Law of the Trust, with it being acknowledged that the exercise of such powers may result in the Trust then meeting the definition of a "foreign trust" under the Code.

There also exists a regulatory safe harbor under Treas. Reg. section 301.7701-7(c)(1) (with which the foregoing language comports) which, if met, will ensure qualification of the trust under the court test. A trust will fall within the regulatory safe harbor for meeting the requirements of the court test if the following three conditions are met:

1. the trust instrument does not direct that the trust be administered outside the United States;
2. the trust is, in fact, administered exclusively in the United States; and
3. the trust does not have an automatic migration provision (also known as an automatic "flee" clause).²⁰

With regard to this last point, an automatic migration or "flee" clause will be deemed to exist if the trust deed provides that an attempt by a United States court to assert jurisdiction or otherwise to supervise the administration of the trust, directly or indirectly, would cause the trust to migrate from the United States (unless limited to the case of foreign invasion or widespread confiscation or nationalization of property).²¹ Obviously, the inclusion a migration or "flee" clause would not be inappropriate for inclusion within a trust drafted for asset protection purposes, but for a trust drafted to meet the regulatory safe

harbor of Treas. Reg. section 301.7701-7(c)(1), such provision would have to be permissive rather than automatic. For a permissive migration or “flee” clause that should not cause the trust to fall outside of the regulatory safe harbor of Treas. Reg. section 301.7701-7(c)(1), consider using the following language:

The Trustees may, by a written declaration executed by them, at any time or times and from time to time, during the Trust Period, as they deem advisable in their discretion for the benefit or security of the Trust Fund or any portion hereof, remove (or decline to remove) all or part of the assets and/or the situs of administration thereof from one jurisdiction to another jurisdiction and/or declare that this Settlement shall from the date of such declaration take effect in accordance with the law of some other state or territory in any part of the world and thereupon the courts of such other jurisdiction shall have the power to effectuate the purposes of this Settlement to such extent. In no event, however, shall the law of some other state or territory be any place under the law of which: (1) substantially all of the powers and provisions herein declared and contained would not be enforceable or capable of being exercised and so taking effect; or (2) this Settlement would not be irrevocable. From the date of such declaration the law of the state or territory named therein shall be the Applicable Law, but subject always to the power conferred by this Section _____ of this ARTICLE _____ and until any further declaration be made hereunder. So often as any such declaration as aforesaid shall be made, the Trustees shall be at liberty to make such consequential alterations or additions in or to the powers, discretions and provisions of this Settlement as the Trustees may consider necessary or desirable to ensure that the provisions of this Settlement shall, *mutatis mutandis*, be so valid and effective as they are under the Applicable Law governing this Settlement at the time the power contained herein is exercised. The determination of the Trustees as to any such removal or change in Applicable Law shall be conclusive and binding on all persons interested or claiming to be interested in this Settlement, and the written declaration executed by the Trustees from time to time effecting any such

change in situs or Applicable Law is hereby deemed to be a term or provision of this Settlement as if included herein on the date of execution of this Settlement by the Settlor.

The “Control Test”

The control test of IRC section 7701(a)(30)(E)(ii) will be met if one or more United States persons have the authority to control all substantial decisions of the trust.²² “Control” is defined as having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions.²³ To determine whether United States persons have control, therefore, it is necessary to consider all persons who have authority to make a substantial decision of the trust (i.e., such as a trust protector), and not merely trust fiduciaries such as trustees.²⁴ Moreover, the Treasury Regulations provide that a United States person will not be considered to control all substantial decisions of the trust if an attempt by any government agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by the United States person, for example, by reason of the operation of an automatic migration provision.²⁵

“Substantial decisions” are defined under the Treasury Regulations as those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law, and that are not merely ministerial.²⁶ The Treasury Regulations note several decisions that are merely “ministerial,” including decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions relating to the trust.²⁷ Other decisions, which the Treasury Regulations regard as a nonexclusive list of “substantial decisions,” include those made with respect to:

1. whether and when to distribute income or corpus;
2. the amount of any distribution;
3. the selection of a beneficiary;
4. whether a receipt is allocable to income or principal;
5. whether to terminate the trust;
6. whether to compromise, arbitrate or abandon claims of the trust;
7. whether to sue on behalf of the trust or to defend suits against the trust;

8. whether to remove, add, or replace a trustee;
9. whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic or vice versa; and
10. the making of investment decisions.²⁸

The inherent complexity in drafting an offshore asset protection trust in compliance with the control test of IRC section 7701(a)(30)(E)(ii) lies in the fact that, in order to draft the trust so that foreign law will govern, a foreign trustee must, of course, be appointed to the trust.²⁹ Significantly, however, this does not preclude the concurrent appointment of one or more United States persons as co-trustees, nor the allocation of rights and responsibilities between the two (or more) trustees so that all "substantial decisions" are to be made only by those co-trustees who fall within the definition of a "United States person." An offshore asset protection trust can thus be structured to meet the control test of IRC section 7701(a)(30)(E)(ii) provided that a person who does not meet the definition of a "United States person" is not then appointed as the trust protector. The drafter might consider using the following language toward this end:

The various rights, powers, authorities, discretions and liberties herein granted to and conferred on the Trustees, or in any manner vested in the Trustees, with respect to this Settlement, the Trust Fund, any assets thereof or under the control of the Trustees, or any matter or thing relating to all or any of the foregoing, shall be exercisable by a majority of the Trustees then in office, but if only two (2) are acting, the joinder of both shall be required unless at such time one (1) of the Trustees is a resident of or domiciled in the same country as the Settlor and the other of the Trustees is not a resident of or domiciled in the same country as the Settlor, in which case the determination of the Trustee who is a resident of or domiciled in the same country as the Settlor shall govern.³⁰ Such majority or individual Trustee, as may be the case, may act without the concurrence or knowledge of

any other Trustees. Any such exercise shall be valid and effective as if all Trustees had concurred therein. At all times the Trustees who so act or shall exercise the various rights (and the like as hereinabove set forth), shall keep proper records thereof, and shall without undue delay inform the other Trustees of any such acts or exercises. Any dissenting or abstaining Trustee who has actual knowledge of any action shall be absolved from personal liability by registering its dissent or abstention with the records of the Trust, but such Trustee shall thereafter act with the other Trustees in any way necessary or appropriate to effectuate the decision of the majority.

The foregoing language relating to the allocation of rights and responsibilities between two or more trustees of an offshore asset protection trust obviously provides that all decisions, whether or not “substantial,” are to be made by the domestic co-trustee or trustees exclusive of any foreign trustee. Such language, therefore, resolves the “control test” issue by painting the responsibilities of the domestic co-trustee or trustees with an extremely broad brush. Alternative drafting language could, however, provide that only “substantial decisions” would be made by the domestic co-trustee or trustees exclusive of any foreign trustee. The problem with such alternative drafting language is that, in practice, it would likely be problematic for the trustees to determine which decisions (other than the ten decisions expressly enumerated as being “substantial” under Treas. Reg. 301.7701-7(d)(1)(ii)) are in fact “substantial” decisions and which decisions are merely “ministerial” decisions.

One final (and extremely important) point must be made in connection with the drafting of an offshore asset protection trust to qualify as a “United States person”; that is, of course, the implications that such drafting raises regarding the asset protection that will ultimately be afforded by such a trust. In this regard, suffice it to say that at some point in time it may become critical from an asset protection perspective that the offshore asset protection trust actually come to be administered exclusively by its foreign trustee or trustees under the exclusive jurisdiction of foreign courts, notwithstanding the fact that the trust would then be deemed a “foreign” trust for United States federal tax purposes. However, since it may be ill-advised for the domestic co-trustee or trustees to actually resign of their own accord at such point in time (since their

“complicity” in the trust’s expatriation could create a contempt of court issue depending upon the timing of the resignation), the foreign co-trustee should have the authority to remove its domestic counterparts under certain circumstances. The foreign trustee could then amend the trust to provide for its administration under the courts of a non-U.S. jurisdiction. The drafter might consider using the following language in this regard:

Upon the happening of any of the events enumerated herein below in this Paragraph, the Trustees who reside in or are domiciled in a given country shall have the power and authority to remove from office one or more of the Trustees who reside in or are domiciled in another given country wherein the event has occurred, with no powers, authorities, benefits or discretions of the Trustees so removed surviving such removal, and thereupon the Trustees so removed shall be divested of the title to any assets belonging to the Trust Fund. The enumerated events are as follows: war, invasion, or revolution; confiscation or expropriation of assets, either with or without “compensation”; the termination of exchange control regulations favorable to the Trust Fund or the implementation of exchange control regulations unfavorable to the Trust Fund; the mandatory liquidation or dissolution of existing Trustees; the mandatory replacement of existing Trustees or the placing of limitations on the powers of Trustees other than in accordance with the terms or provisions hereof; the devaluation or inconvertibility of the currency in which Trust Fund assets are held; serious governmental threat to the ownership or free transfer of private property by citizens of the jurisdiction; the threat of or the actual suspension or abrogation in whole or in part of this Settlement or of any contract with a party involved in the Trust; the compulsory conversion of the Trust Fund assets into the currency of the jurisdiction; or the threat of or the actual compulsion of the Trustees to sell, transfer or otherwise dispose of Trust Fund assets in a manner inconsistent with the terms and provisions of this Settlement. Removal pursuant to this power shall be effective immediately upon written notice thereof to the Trustee so removed. In such event, the Trustee authorized to exercise this power (which may only be exercised by the Trustees’ unani-

mous action if there shall be more than one (1) such Trustee) shall have the sole power and authority to designate the successor or successors to the Trustee or Trustees who are so removed, or to otherwise determine in the exercise of sole and absolute discretion that there shall, for the time being or for any time, not be a successor or successors in office to the Trustees so removed.

Drafting for the Possibility of Duress

Introduction

The asset protection afforded through the use of an offshore “asset protection” trust is, in the first instance, grounded in the fact that a self-settled trust that designates the law of some foreign “asset protection” jurisdiction as governing should be considered valid even though the litigation forum might (and likely would) be a jurisdiction that would not permit such a trust to be validly created under its own law.³¹ Notwithstanding the existence of substantial legal authority underlying this position, however, several cases that have attempted to deal with particularly egregious fact situations have crafted a public policy exception to the conflict of laws principle that the settlor’s designation of the trust’s governing law is to be respected.³² Asset protection planners, therefore, frequently recommend that the assets of an offshore asset protection trust be custodied offshore in order to mitigate the potential problems that might exist if the settlor’s designation of governing law is not, in fact, respected in the forum jurisdiction.

The physical presence of the trust fund offshore is, however, obviously an attempt to deny effect to the issuance of any court order adverse to the trust fund by vitiating the court’s jurisdiction. To the extent that the offshore asset protection trust has no other ties to the forum state, the physical presence of the trust fund offshore will almost certainly cement the trust’s asset protection. Where, however, there exists a domestic co-trustee or a domestic protector, whether or not such person is also the settlor, the forum court may attempt to enforce its order against the trust fund by exerting duress over such person or persons. Alternatively, the domestic court might attempt to attribute control to the settlor notwithstanding that (i) the settlor holds no position of authority over the offshore asset protection trust, and (ii) all of the trustees and protectors of the offshore asset protection trust are foreign corporate entities. If the court attributes control to the

settlor, the court may then attempt to compel compliance with its order by holding the settlor himself in contempt.

The Anti-Duress Clause

In order to preclude the effect of duress, the inclusion of an “anti-duress” clause in the trust settlement should be considered. An anti-duress clause provides that to the extent that a person with the power to give direction to the trustee is not acting of his or her own free will (such as if such person were acting under a court order) such direction should be ignored. A typical anti-duress clause might be worded as follows:

The Settlor directs that this Settlement be administered consistent with its terms, free of judicial intervention and without order, approval, or other action of any court. To the extent any person is granted the power hereunder to do any act or to compel any act on the part of one or more of the Trustees, or has the authority to render advice to one or more of the Trustees, or to otherwise approve, compel, or veto any action or exercise any power which affects or will affect this Settlement, each Trustee is directed, to the extent the respective Trustee then in office would not be subject to personal liability or personal exposure (for example, by being held in contempt of court or other such sanction by a court having jurisdiction over the respective Trustee): (1) to accept or recognize only instructions or advice, or the effects of any approval, veto, or compelled action or the exercise of any power, which are given by or are the result of persons acting of their own free will and not under compulsion of any legal process or like authority; and (2) to ignore any advice or any directive, veto, order, or like decree, or the results or effects thereof, of any court, administrative body or any tribunal whatsoever or of past or present Trustees, or of any Protector hereunder, or of any other person, where: (a) such has been instigated by directive, order, or like decree of any court, administrative body or other tribunal, or (b) the person attempting to compel the act, or attempting to exercise the authority to render advice, or otherwise attempting to compel or veto any action or exercise any power which affects or will affect this Settlement, is not a person either

appointed or so authorized or the like pursuant to the terms and conditions of this Settlement.

Interestingly, there is some question as to whether an anti-duress clause is actually necessary to protect the trust fund from the effects of duress. Consider, for example, the Cook Islands proceedings in the case of *Federal Trade Commission v. Affordable Media LLC* (colloquially known as the “Anderson” case). In those proceedings, the Federal Trade Commission of the United States compelled the settlors of a Cook Islands asset protection trust, in their capacity as the protectors thereof, to execute a deed removing the then current Cook Islands trustee and, in effect, appointing the Federal Trade Commission as the new trustee with the ultimate goal of effecting a repatriation of the trust fund. The then current Cook Islands trustee applied to the Cook Islands court for a declaratory judgment as to the effect of such a document.

In a well-reasoned decision, the Cook Islands court held that the Federal Trade Commission fell within the definition of an “Excluded Person” under the trust deed. Since the trust deed provided that “[n]o power of the Protector shall be exercisable by or for the benefit of an Excluded Person,” the court held the document to be invalid as having been made for the benefit of an Excluded Person. Therefore, it appears as though careful drafting of the trust settlement to exclude creditors from any benefit could avoid the need for an anti-duress clause (which might serve only to anger the domestic courts). Where the offshore asset protection trust is to be domiciled in the Cook Islands, at least, the language used in the Anderson’s trust should be used. That language provided:

The following list of excluded persons shall be interpreted in its broadest sense, and shall include the following persons:

1. All court, administrative or judicial bodies, except for the court, administrative or judicial bodies organized or empowered under the laws of the Cook Islands.
2. Any and all creditors, claimants, judgment creditors, etc. of any Settlor, of any Trustee, or any Discretionary Beneficiary, or any other Beneficiary under the Settlement.

Ultimately, however, the decision as to whether to include an anti-duress clause must rest upon an attempt at balancing the desired cer-

tainty of a binding contractual obligation upon the trustee to act in a certain way under certain delineated circumstances that are defined as events of “duress” against what may be perceived as a blatant, but potentially unnecessary, attempt to frustrate the authority of the domestic courts.

The Contempt of Court Issue

In addition to protecting the trust fund against the possibility of repatriation under duress, however, the inclusion of an anti-duress clause might also be thought to enhance the protection afforded to the settlor, or to the domestic co-trustee or protector, under the “impossibility of performance” doctrine if the trust fund is not repatriated following the issuance of an order by a domestic court for such person to do so. By way of brief background in this regard, impossibility of performance is a defense to civil contempt since civil contempt is not intended as a punishment (which would implicate certain constitutional rights and concerns), but rather as a coercive measure presumed to be necessary to obtain compliance with a court order.³³ In recognition of this principle, the United States Supreme Court in its 1948 decision in *Maggio v. Zeitz*³⁴ pointed out that:

. . . to jail one for a contempt for omitting an act he is powerless to perform would reverse this principle and make the proceeding purely punitive, to describe it charitably. At the same time, it would add nothing to the bankrupt estate.³⁵

Further, “. . . no matter how reprehensive the conduct is it does not ‘warrant issuance of an order which creates a duty impossible of performance, so that punishment can follow.’ If the record establishes that there in fact is a present inability to comply with a production order, the ‘civil [contempt] inquiry is at an end’ insofar as the court may coerce compliance because obedience to the order is no longer within the contemnor’s power.”³⁶

Notwithstanding the foregoing, however, and seemingly in large part because the inclusion of an anti-duress clause has the effect of “. . . frustrating domestic courts’ jurisdiction . . . ,”³⁷ it has been held that “[i]n the asset protection trust context . . . the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court’s order will be merely a charade rather than a good faith effort to com-

ply.”³⁸ Alternately, it might be said that the domestic courts will not permit themselves to be frustrated by the expediency of an anti-duress clause unless the factual circumstances surrounding the assertion of such defense are not overly suggestive of “game-playing” with the domestic court. In this vein, and notwithstanding the fact that it is logically inconsistent with the Supreme Court’s holdings in this area, it has been held by several courts that a self-induced impossibility of performance should not be recognized as a defense to contempt of court. For example, in *Goldberg v. Lawrence (In re Lawrence)*,³⁹ the Court stated:

While impossibility is a recognized defense to a civil contempt order, the law does not recognize the defense of impossibility when the impossibility is self created. . . . The Debtor has testified that he voluntarily established the Alleged Trust in 1991. Since the provisions which he now relies upon in order to substantiate his inability to comply with the Turn Over Order were of his own creation, he may not claim the benefit of the impossibility defense. Giving credence to the Debtor’s argument would be tantamount to succumbing to the pleas for sympathy from an orphan who has killed his parents.⁴⁰ [Internal citations omitted]

Of course, a significant factor which likely influenced the Bankruptcy Court’s analysis in *Lawrence* is the fact that Mr. Lawrence, in what might certainly be seen as “game playing” settled the foreign asset protection trust at issue a mere 66 days before a \$20 million arbitration award was rendered against him. Seemingly more accurate than the Bankruptcy Court’s statement in *Lawrence* that “. . . the law does not recognize the defense of impossibility when the impossibility is self created . . .” would be a statement to the effect that the courts might not recognize the defense of impossibility of performance where the impossibility is self-created in close temporal proximity to the issuance of the court order.

In consequence of the foregoing, appropriate asset protection planning must involve not only the possible inclusion of an anti-duress clause in the trust settlement whenever a domestic co-trustee or domestic protector exists, but also a pro-active plan for minimizing the appearance of domestic control at a point in time as remote as possible from the issuance of an adverse court order. Therefore, although it

may be permitted under the law of certain offshore jurisdictions, an offshore asset protection trust should never be structured so that the settlor is the trustee, or even a co-trustee, since the very nature of a trustee is to have control over the trust. In addition, generally, the settlor should not be a protector since such status also suggests a measure of control over the trust fund.⁴¹ Many settlors will, nevertheless, insist upon being a protector as a “cost” of establishing the trust due to concerns over the fidelity of an institutional trust company on the other side of the world. In such instances, careful consideration must be given to appropriately circumscribe the protector’s powers. At the very least, the protector’s powers should be drafted as purely negative (i.e., the power to veto certain trustee actions, but an absence of authority to institute any such actions).⁴²

Ideally, a prospective settlor of an offshore asset protection trust would, therefore, create a trust that from its inception relies solely upon a foreign corporate trustee and foreign corporate protector. To the extent that the prospective settlor is unwilling to do so (perhaps because such a trust would be deemed a “foreign trust” under IRC section 7701(a)(31)), any domestic co-trustee or domestic protector would resign or be removed at the first sign that the trust’s ability to provide asset protection might be challenged.

Drafting in Consideration of United States Gift and Estate Taxes

Incomplete Gifts

Drafting an asset protection trust in consideration (i.e., toward the minimization) of United States federal gift and estate taxes is perhaps the simplest of the drafting considerations discussed herein since it involves a well-defined body of statutory law, coupled with an extensive regulatory scheme; to wit, the United States Internal Revenue Code and the Treasury Regulations thereunder. Moreover, in large part, drafting an offshore asset protection trust toward the goal of minimizing United States federal gift, estate, and generation-skipping transfer taxation differs little from that required for the drafting of purely domestic, non-asset protection trusts.

From a transfer tax perspective, an offshore asset protection trust will generally be crafted so that the transfer of property to the trust will be deemed an “incomplete gift” pursuant to Treas. Reg. section 25.2511-2(c) by having the settlor retain a limited (non-general) power of appointment over the trust, since the alternative would require the

payment of a United States federal gift tax of up to almost 50 cents for each dollar transferred to the trust.⁴³ More likely, if the offshore asset protection trust were structured so that transfers to the trust would constitute completed gifts, the immediate gift tax cost would likely preclude most prospective settlors from protecting anything more than could be sheltered from tax by the client's remaining applicable exemption amount (and, perhaps that of the client's spouse, as well). This incomplete gift tax result is also important so that the trustee need not feel circumscribed in the exercise of the trustee's discretion to distribute property to or for the benefit of the settlor, as would likely be the case if the settlor has previously paid a gift tax (or exhausted some portion or all of the settlor's applicable exemption amount) in transferring that property to the trust. From an estate tax perspective, of course, the retention of even a limited testamentary power of appointment is sufficient to cause inclusion in the settlor's gross estate of the trust fund remaining at the time of the settlor's death.⁴⁴

A fairly fine line must be drawn by the drafter, however, so that the settlor's retention of "dominion and control" over the offshore asset protection trust is sufficient to cause transfers to the trust to be deemed incomplete gifts, yet insufficient to make the trust available to the settlor's creditors. In this regard, the settlor's creditors are likely to argue that any indicia of the settlor's retention of control is evidence that the asset protection trust is a sham that should not be respected by the courts. Notwithstanding the foregoing, however, as noted above the reservation of a testamentary "non-general" power of appointment⁴⁵ in the settlor (i) would render transfers to the offshore asset protection trust incomplete,⁴⁶ and (ii) should not expose the trust to claims of the settlor's potential future creditors.⁴⁷

The following language provides an example of a testamentary non-general power of appointment that can be included in an asset protection trust for this purpose:

Upon the death of the Settlor, the Trustees shall distribute the Trust Fund or any part thereof to such one or more persons (other than the Settlor's estate, the Settlor's creditors, or the creditors of the Settlor's estate), on such terms and conditions, and in such proportions, either outright or in trust, as the Settlor may appoint by a last will and testament or codicil specifically referring to and exercising this power of appointment.

An alternative to the foregoing clause might limit the class of persons to whom the settlor could appoint the trust fund upon death to certain named individuals or to a certain specified class of persons (i.e., the settlor's descendants); such a limitation should not, however, be necessary for asset protection purposes. Moreover, the inclusion of a broader testamentary non-general power of appointment permits the testamentary property disposition to remain as flexible as is the case with the settlor's other property that might be left to pass by last will and testament (notwithstanding that the offshore asset protection trust itself is irrevocable, as is required to meet the settlor's asset protection goals).

From a tax-reporting perspective, it is generally thought that an incomplete gift is required to be reported on a timely filed gift tax return, Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*,⁴⁸ although there is some ambiguity in this regard since the language of the applicable Treasury Regulation is permissive rather than mandatory. Nevertheless, and although an incomplete gift necessarily will generate no gift tax liability, for asset protection purposes it is important to properly report the transfer of property to the trust since (i) it evidences the settlor's position that the property was transferred to the trust, and (ii) in many cases the reporting of the gift on a timely filed gift tax return may be the only formal documentation reflecting the transfer.

Completed Gifts

Where the settlor of an asset protection trust desires to obtain an overall tax savings under the trust and is relatively (but not entirely) certain that the settlor's lifestyle can be maintained without recourse to the transferred funds, the trust can be structured so that transfers to the trust will be deemed "completed," rather than "incomplete," gifts. If a completed gift result is desired, the issue is not so much a drafting issue as a situs issue, since a self-settled trust cannot, in most jurisdictions, be structured so that transfers to the trust will be deemed "completed" gifts. Specifically, IRC section 2036(a)(1) will, in most jurisdictions, cause estate inclusion where the settlor has retained a beneficial interest notwithstanding the fact that it might be wholly within the discretion of one or more independent trustees since, in most jurisdictions, "[w]here a person creates a trust for his own benefit, a trust for support or a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."⁴⁹ Where a settlor's creditors can reach

the settlor's interest in the trust, the settlor may also be deemed to have an indirect power to revoke or terminate the transfer of assets by incurring debts and leaving his or her creditors no recourse other than to the transferred property.⁵⁰

In an asset protection jurisdiction, however, the settlor's creditors will not be able to reach the trust's assets and, as a consequence, the settlor is not deemed to have retained a beneficial interest in the trust within the meaning of IRC section 2036(a)(1). Therefore, ". . . if and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in section 25.2511-2 of the regulations."⁵¹ Interestingly, however, this does not necessarily mean that the trust will also be excluded from the settlor's estate. In a 1998 private letter ruling, the Internal Revenue Service refused to rule on this issue stating, in essence, that excludability from the settlor's estate is dependent upon the facts and circumstances existing at the settlor's death.⁵² If, however, there exists no implied agreement to distribute income or capital to the settlor, it would seem clear that there is no legal basis for inclusion.

Internal Revenue Code Section 684

Whether a "foreign" asset protection trust has been structured so that gifts to the trust are deemed "complete" or "incomplete" is also of potentially great significance from a United States income tax perspective pursuant to IRC section 684. Specifically, IRC section 684(a)(1) provides that any transfer of property by a United States person to a "foreign" trust will be treated as a sale or exchange for an amount equal to the fair market value of the property transferred. However, since IRC section 684(b) provides that the tax is not imposed upon the transfer of appreciated property to a grantor trust (which a self-settled asset protection trust necessarily would be under IRC section 677), taxation is deferred until grantor trust status terminates upon the death of the grantor (if not earlier terminated). At that time, a capital gains tax will generally be imposed upon the excess of the property's fair market value over its adjusted basis. An exception is afforded under Proposed Treasury Regulation section 1.684-3(c), however, for ". . . 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).” Therefore, the tax imposed under section 684 is problematic only for trusts to which the transfer of property would be deemed a completed gift, and hence not includible in the U.S. transferor’s gross estate. Therefore, settlors of “foreign” trusts are cautioned that if the trust might hold substantially appreciated property upon the settlor’s death, the trust should be structured either (i) so that transfers to the trust will be deemed incomplete gifts includible in the settlor’s gross estate, or (ii) as a hybrid foreign trust so that section 684(a)(1) will be inapplicable in the first instance.

Conclusion

The drafting issues that are discussed herein, being constrained to a single chapter instead of comprising an entire treatise, obviously serve merely to scratch the surface of the issues attendant to the drafting of a well-thought-out and effective offshore asset protection trust. The complexity inherent in such trusts may be daunting to those who are attempting to draft such a trust for the first time. The effort has its own reward, however, since when such a trust is ultimately executed and funded, the client will be well protected against the numerous pitfalls of our litigious modern society.

Notes

1. In this regard, it is significant to note that although a trust is merely a relationship for trust law purposes, it may actually be a separate entity for income tax purposes. In such cases, an entirely separate body of income tax law applies to trusts. *See* I.R.C. § 641, *et seq.*

2. The terms “offshore” and “foreign” are sometimes used interchangeably herein, but only when they precede the phrase “asset protection trust.”

3. A “protector” is a person sometimes appointed under a trust agreement to exercise certain oversight powers over the trustee’s administration of the trust. For the most part, the trust protector’s powers are constructed in the negative (*i.e.*, as veto powers), although the trust protector is frequently given an affirmative power to remove and replace the trustee.

4. The seven states that have adopted specific legislation allowing self-settled spend-thrift trusts are Alaska, Delaware, Missouri, Nevada, Oklahoma, Rhode Island, and Utah.

5. *See* I.R.C. § 6048.

6. In addition, Part 3 of Schedule B, *Interest and Ordinary Dividends*, to Form 1040, *U.S. Individual Income Tax Return*, requires the taxpayer to indicate (i) whether at any time during the prior calendar year the taxpayer had an interest in, or a signature or other authority over, a financial account in a foreign country, and (ii) whether during the prior calendar year the taxpayer received a distribution from, or was the grantor of, or transferor to, a foreign trust.

7. See Treas. Reg. § 301.7701-7(a)(2): “[f]or purposes of the regulations in this chapter, the term *domestic trust* means a trust that is a United States person.”

8. I.R.C. § 7701(a)(30).

9. I.R.C. § 7701(a)(31).

10. Prior to enactment of the Small Business Job Protection Act of 1996 (P.L. 104-188, § 1907(a)), whether a trust was deemed foreign or domestic was determined under a “facts and circumstances” test, primarily focusing on the nationality of the trustees, the place of organization of the trust, the place of administration of the trust, the location of the assets of the trust, the citizenship of the settlor of the trust, and the citizenship of the beneficiaries of the trust. See *Maximov v. United States*, 373 U.S. 49 (1963), *aff’g* 299 F.2d 565 (2d Cir. 1962).

11. Treas. Regs. §§ 301.7701-7(a)(1)(i) and (c).

12. Treas. Regs. §§ 301.7701-7(a)(1)(ii) and (d).

13. Treas. Reg. § 301.7701-7(a)(1)(i).

14. Treas. Reg. § 301.7701-7(c)(3)(iv).

15. *Id.*

16. Treas. Reg. § 301.7701-7(c)(4)(i)(D).

17. Treas. Reg. § 301.7701-7(c)(3)(iii).

18. Treas. Reg. § 301.7701-7(c)(3)(v).

19. With such person, of course, being a United States person under I.R.C. § 7701(a)(31)(A), (B) or (C); to wit, a citizen or resident of the United States, a domestic partnership or a domestic corporation, respectively.

20. Treas. Reg. § 301.7701-7(c)(1).

21. Treas. Reg. § 301.7701-7(c)(4)(ii).

22. Treas. Reg. § 301.7701-7(a)(1)(ii).

23. *Id.*

24. *Id.*

25. Treas. Reg. § 301.7701-7(d)(3).

26. Treas. Reg. § 301.7701-7(d)(1)(ii).

27. *Id.*

28. Treas. Regs. §§ 301.7701-7(d)(1)(ii)(A) through (J).

29. See, e.g., section 2 of the Cook Islands International Trusts Act (1984).

30. Use of this particular clause presumes, of course, that the settlor is himself a “United States person” pursuant to I.R.C. § 7701(a)(30)(A).

31. See, e.g., RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 273 (“Whether the interest of a beneficiary of . . . [an inter vivos] trust of movables is assignable by him and can be reached by his creditors is determined . . . by the local law of the state, if any, in which the settlor has manifested an intention that the trust be administered . . .); see also 2A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 626, at 419 (4th ed. 1989) (“If the settlor creates a trust to be administered in a state other than that of his domicil, the law of the state of the place of administration, rather than that of his domicil, ordinarily is applicable. Thus a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary’s interest. . . . This permits a person who is domiciled in a state in which

restraints on alienation are not permitted, to create an inter vivos trust in a state where they are permitted and thereby take advantage of the law of the latter state . . .”).

32. See, e.g., *Marine Midland Bank v. Portnoy (In re Portnoy)*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996); *Sattin v. Brooks (In re Brooks)*, 217 B.R. 98 (Bankr. D. Conn. 1998).

33. See, e.g., *United States v. Rylander*, 460 U.S. 752 (1983). See also *United States v. Bryan*, 339 U.S. 323, 330 (1950) (“Ordinarily, one charged with contempt of court for failure to comply with a court order makes a complete defense by proving that he is unable to comply.”). A distinction must be made, however, between civil *coercive* contempt and civil *compensatory* contempt; since civil compensatory contempt is designed to compensate for a loss, impossibility of performance is not a defense thereto. See, e.g., *United States v. Asay*, 614 F.2d 655 (9th Cir. 1980).

34. *Maggio v. Zeitz*, 333 U.S. 56 (1948).

35. *Id.* at 72.

36. *Falstaff Brewing Corp., et al. v. Miller Brewing Co., et al.*, 702 F.2d 770, 781 (9th Cir. 1983), *citing Maggio v. Zeitz, supra* note 34.

37. Federal Trade Comm’n v. *Affordable Media LLC*, 179 F.3d 1228 at 1240.

38. *Id.* at 1241.

39. 227 B.R. 907 (S.D. Fla. 1998).

40. See also *Pesaplastic, C.A. v. Cincinnati Milacron Co.*, 799 F.2d 1510, 1521 (11th Cir. 1986) (“where the person charged with contempt is responsible for the inability to comply, impossibility is not a defense to the contempt proceedings”); *In re Power Recovery Systems, Inc.*, 950 F.2d 798, 803 (1st Cir. 1991) (“ . . . a party may defend contempt and failure to comply on the grounds that compliance was impossible; self-induced inability, however, does not meet the test”); *In re Coker (The American Ins. Co. v. Coker)*, 251 B.R. 902, 905 (M.D. Fla. 2000) (“ . . . Debtors’ proposed defense of impossibility is invalid in that the law does not recognize the defense of impossibility when the impossibility is self-created.”).

41. Federal Trade Comm’n v. *Affordable Media LLC*, 179 F.3d 1228 at 1241 (“ . . . that the Andersons were in control of their trust is well supported by the record given that the Andersons were the protectors of their trust. A protector has significant powers to control an offshore trust.”).

42. In particular, the settlor, as protector, should *not* have the power to determine whether an event of duress has occurred, since, as the Ninth Circuit Court of Appeals has duly noted: “. . . [i]t is clear that the Andersons could have ordered the trust assets repatriated simply by certifying to the foreign trustee that in their opinion, as protectors, no event of duress had occurred.” *FTC v. Affordable Media LLC*, 179 F.3d 1228 at 1243.

43. Subject, of course, to an applicable exclusion amount of US \$1 million under I.R.C. § 2010(c).

44. See I.R.C. § 2036(a)(2).

45. A “non-general” power of appointment is one under which the power holder may appoint the subject property to anyone other than to himself or herself, his or her estate, or the creditors of either. See I.R.C. § 2041(b)(1).

46. “A gift is . . . incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable stan-

ard.” Treas. Reg. § 25.2511-2(c). More specifically, “. . . [i]f a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift.” Treas. Reg. § 25.2511-2(b).

47. *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-7.4. *See also* RESTATEMENT (SECOND) OF PROP. § 13.1.

48. Treas. Reg. § 25.6019-3.

49. RESTATEMENT (SECOND) OF TRUSTS § 156.

50. *See, e.g.*, Estate of German v. Commissioner, 7 Cl. Ct. 641 (1985).

51. Rev. Rul. 76-103, 1976-1 C.B. 293; *see also* Priv. Ltr. Rul. 97113946.

52. Priv. Ltr. Rul. 98-37-007.