

TEN COMMON MISCONCEPTIONS REGARDING OFFSHORE ASSET PROTECTION PLANNING

By David L. Lockwood

Sophisticated estate planning often includes formidable asset protection features entailing the use of foreign situs trusts in conjunction with domestic limited partnerships. Strategic advantages are gained by an asset protection planning trust (APT) being governed by foreign laws that determine the rights or interests third parties may have with respect to the APT's assets. In contrast, a domestic or U.S. trust may be as much a target for litigation as the client who created the trust due to broader rights being granted to settlors' creditors under U.S. law. Further, although a family limited partnership (FLP) may create impediments that could thwart a lesser level of attack, FLPs used alone are insufficient asset protection planning vehicles for clients to withstand an all out siege. Even among some experienced planners, however, there are several misconceptions surrounding the use of foreign APT structures.

Misconception No. 1 – The client must forego all benefit from or control over the protected assets.

When combined, APTs and FLPs offer clients a rare combination of control over, benefit from, and protection for their assets. For instance, a husband and wife can retain control over assets placed within the FLP by virtue of their being the only general partners of the FLP. At a time when the waters are calm with respect to creditor-sensitive issues, they can transfer a significant limited partner's interest to the APT. The APT typically is a discretionary trust during the clients' lifetimes for the benefit of the clients, their children, their grandchildren and any other person or entity (*e.g.*, a charity) to whom the clients may wish to assure benefits might be provided.

Although during any non-crisis period the APT is controlled directly by the action of the trustees, under the laws of many offshore jurisdictions the clients can retain some degree of indirect control by serving as the protectors of the APT. As protectors, the clients can retain the power to remove and replace trustees (both U.S. and foreign); but, more importantly, the clients also can exercise advance veto powers over significant trustee decision-making authorities and powers. For instance, the exercise of typical trustee powers to (i) sell trust assets, (ii) reinvest the sale proceeds, and (iii) make distributions to or for the benefit of any of the several beneficiaries can all be subject to the trustees' obtaining advance approval from the protectors. Note that the protectors' veto power is a negative power rather than an affirmative power and that the protectors are given no fiduciary powers with respect to trust corpus. This plus the existence of an "impossibility of performance" defense soundly based in easily provable facts should forestall the development of any serious risk of contempt of court issues as discussed in the now infamous federal district court decision of last August (*Eulich v. United States*, 2004 WL 1844821 (N.D.Tex. 2004)).

Misconception No. 2 – The sole purpose of such planning is to force the end game to be played in a jurisdiction with "debtor friendly" legislation.

Ideally, each planning structure should be designed to allow the clients to win any dispute over any issue in all jurisdictions. This is not to say that a client should refrain from creating an asset protection plan unless he or she is guaranteed to win in any or all jurisdictions, but rather this suggests that a careful plan should render favorable results everywhere as determined under then existing applicable law.

For instance, every state in the United States either follows the Statute of Elizabeth or a more modern statutory derivative thereof to unwind transfers made with the intent to hinder, delay or defraud creditors.

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The specifics of a given U.S. jurisdiction's fraudulent conveyance laws are beyond the scope of this article; but, generally, transfers may be made in anticipation of some future unaccrued and, as yet, unidentifiable claim or liability so long as the transferor is solvent (*i.e.*, able to meet his or her liabilities, contingent or otherwise, as they are expected to arise in the ordinary course of events) both before and after the transfer.

In other words, this type of planning must be completed prior to the transferor's problem arising. Asset protection planning is a vaccine for the prevention of creditor related "diseases" and is not a cure for those already contracted. (On the other hand, if the clients can quantify and isolate a given problem or disease, a vaccine can be administered to impede contagion from other future problems or diseases as discussed in No. 8, below.)

So long as transfers are made outside the scope of a given state's fraudulent conveyance laws, the clients "should" win even in the domestic forum. However, they and their assets will have been left subject to the vagaries of the U.S. legal system and its seemingly ever-expanding theories of recovery against deep-pocketed defendants. In fact, the uncertainty attached to the potential retroactive application of new, heroic and original theories of recovery (whether related to fraudulent conveyance analysis or otherwise) may be what prompted the clients to explore asset protection planning in the first place. So, while one primary goal of this type of planning may be to move the playing field to a "debtor friendly" jurisdiction, the planning also must take into account the laws of the domestic forum. Failure to do so exposes the practitioner to a myriad of ethical issues.

Misconception No. 3 – Charging order protection associated with FLPs and LLCs will render sufficient protection.

Obviously, the domestic protection gained from the use of FLPs could be retroactively eliminated by a domestic court order in the absence of the foreign element of the plan. The popularity of FLPs is attributable to their rendering a client's assets unattractive to a potential future creditor, since most states' partnership laws provide that the remedy of a creditor of a partner is a "charging order." A charging order is a relatively impotent remedy because (i) it does not allow the creditor to seek a forced sale of the debtor partner's partnership interest; (ii) it limits the creditor to receiving from the partnership anything that the debtor partner otherwise would have received (yet the debtor can still retain the control as a general partner over whether anything will actually be distributed); and (iii) the IRS arguably will treat a creditor having a charging order as a substitute partner for federal income tax purposes, thereby potentially attributing taxable income to the creditor despite his not receiving an actual distribution. (Rev. Rul. 77-137, 1977-1 C.B. 178).

The real advantage of using FLPs, however, is to separate ownership from control—not the charging order remedy. Unfortunately, most clients still will need to access the assets of the FLP. If they were to do so, a judgment creditor with a charging order would receive the partnership distribution instead. Against a creditor willing to wait indefinitely for its pound of flesh, this limited type of domestic planning establishes a waiting game only and, therefore, is of little help to clients lacking unlimited staying power.

Secondly, chinks in the armor of charging order protection have begun to appear on the domestic scene. Courts in seven states have held that a judgment creditor was not limited in its collection remedies to obtaining a charging order and was in fact able to attach and sell a limited partner's interest in an FLP in order to satisfy a judgment that a creditor had obtained some years earlier. Since the underlying rationale behind charging order protection is to protect the partnership's business from the problems of a given individual partner and since most FLPs in this context are not engaged in a trade or business but rather are only holding passive investment assets, it would not be surprising to see this line of reasoning substantially erode even further the limited protection that charging orders afford debtor partners. The more general

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problem is, of course, that the clients again remain subject to the whims of the domestic system when one limits the planning to domestic tools.

Misconception No. 4 – Establishing a waiting game is the only positive outcome that can arise from asset protection planning.

Any sophisticated planning structure will allow a dispute to be decided in the trust's home court. It is not that the clients would necessarily derive some home field advantage via favoritism or inconsistent interpretation of existing law. Just the opposite. The clients can be in the position of accessing consistently applied law derived from clear-cut statutes setting forth rules that, once complied with, can be depended upon to mean what they say without retroactive change.

Recall that the APT, even while a creditor threat exists, still is a discretionary trust for the benefit of all of the designated beneficiaries. If the foreign corporate trustee were to make a distribution to a beneficiary after a judgment has been entered against him or her, the judgment creditor easily could execute against that distribution. On the other hand, a distribution for the benefit of that beneficiary cannot be seized if it is made directly to some third party in return for goods or services received. In practice, bills may be paid by the foreign corporate trustee for the duration of the crisis. As a result, the clients' lifestyles need not miss a beat, even while under attack. This outcome creates unlimited staying power and is far superior to a mere waiting game.

Misconception No. 5 – Protected assets must be moved offshore from the inception of the plan.

The best result often is accomplished by removing both the clients' assets that are to be protected and the persons in control of those assets from the domestic legal system. A properly drafted APT allows the foreign corporate trustee to remove the U.S. trustees upon the occurrence of specified events. As a result, the foreign corporate trustee for the duration of the crisis often becomes the sole trustee. The foreign corporate trustee then also could cause the dissolution and liquidation of the FLP along with the consequent distribution of FLP assets to the APT. Then the assets (both those that had been transferred to the APT initially and those distributed from the FLP) physically could be moved offshore (*i.e.*, outside the geographic and political boundaries of the U.S.). Often, assets are only offshore for the duration of the crisis. It should be emphasized that this action is not taken by the clients, who long ago parted with ownership of the assets upon the initial funding of the trust, but by the foreign trustee in furtherance of its fiduciary duty to preserve the trust income and corpus for the benefit of the beneficiaries, not the creditors of the settlor.

Misconception No. 6 – During a crisis the protected assets should be located in the offshore jurisdiction where the trust maintains its situs and which was chosen for its specific asset protection legislation.

During the pendency of the Anderson case (Federal Trade Commission v. Affordable Media, LLC, et al, 179 F.3d 1228 (9th Cir. 1999)) examined at length in numerous articles that deal with pertinent contempt of court issues, assets were surprisingly invested in a Cook Islands bank account pending the resolution of U.S. and Cook Islands court procedures. Although it is hard to imagine that any dispute litigated in the chosen foreign jurisdiction would be so egregious that the party challenging the APT's ownership and control of property might win in that chosen jurisdiction and, therefore, receive a remedy from that chosen jurisdiction's courts, nevertheless a planner should at least academically recognize the possibility that this could happen. Anticipating this result, a planner may wish to advise that such assets be positioned in yet a third jurisdiction (or, even better still, divided between multiple jurisdictions all of which are other than the chosen foreign jurisdiction). Diversity of jurisdictions in this context creates a springboard for multiple potential planning opportunities.

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Misconception No. 7 – Asset protection planning entails hiding or obscuring the trail to assets.

The properly drafted APT structure is not merely an obstacle for opponents of the clients to hurdle. Reliance should never be placed upon obscuring the trail to assets or upon the hare staying one step ahead of the pursuing wolf pack. While these may indeed be lesser impediments that could frustrate some opponents, a proper plan assumes that each potential opponent will be an emotional, deep-pocketed judgment creditor who is willing to travel to the ends of the earth in order to pursue the assets. Furthermore, a proper plan assumes that such an opponent will eventually clear any interim hurdles and will through the discovery process or otherwise obtain a roadmap to protected assets. The planning ultimately must work because it is legally sound.

Misconception No. 8 – There is nothing positive to be gained by adopting a plan after a problem arises.

As set forth above, the time to protect assets generally is before the onset of some crippling litigation which may cause the transfer of property to be considered fraudulent with respect to that potential judgment creditor. While true, there still is much that can be gained on behalf of a client who already has an existing problem (*i.e.*, who already has something pending, threatened or expected). For instance, if the client's exposures from the existing problem can be quantified by an expert in such matters, the client purposely could leave out of the asset protection structure an amount of assets sufficient to meet these existing exposures. The transferred assets, on the other hand, would not only be protected from other problems that may develop regarding this client, but they also would be protected from this existing problem ballooning into something that no reasonable person could have imagined (let alone predicted) at the time that the transfers into the structure were made.

IRS FORM 8892:

The IRS has issued Form 8892 to be used for application for extension of time to file Form 709 (gift tax return) when the taxpayer does not apply for an extension of time to file Form 1040. Form 8892 should also be used when a four month extension is obtained for filing of Form 1040 but the taxpayer wants an additional extension of time to file the Form 709. The total extension available is 6 months from the due date of the Form 709. Prior to the issuance of Form 8892 in January, 2005, these extension requests were made by letter.

Misconception No. 9 – Real estate located in the U.S. cannot be protected.

As mentioned above, there may come a time in a crisis when both the persons in direct control of assets and the assets themselves should be removed from the jurisdiction of the court where a claim has been or might be brought against a client. If, for instance, a U.S. judge can gain jurisdiction over either, the judge may attempt to apply the law of a jurisdiction other than the chosen offshore jurisdiction in direct contradiction to existing conflict of laws or choice of laws principles; and the end result instead may then be decided pursuant to U.S. laws. How does one remove real estate from the U.S. for the duration of a crisis?

It's not the dirt that a client wants to protect. Rather, it is the equity in the dirt that needs protection. If well in advance of a crisis developing an unrelated lender is given a first lien deed of trust or a first mortgage absorbing all of the equity out of the dirt, then the borrowed proceeds can be moved offshore for the duration of the crisis; and the planner will have converted an immovable asset into a movable asset.

Misconception No. 10 – Sophisticated offshore asset protection planning is tax motivated.

The typical asset protection component of estate planning is tax neutral. No tax benefit is gained, and no tax detriment is imposed. The typical APT is a grantor trust for U.S. federal income tax purposes. The

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arrangement is usually gift tax neutral (in that the transfers are incomplete for U.S. federal gift tax purposes and the gift tax will not apply until and unless a later transfer ultimately is made to someone other than the transferor) and estate tax neutral (in that assets in the APT are included in the client's gross estate for U.S. federal estate tax purposes and, as a result, normal estate and generation skipping transfer tax motivated dispositive provisions may be included just as with domestic planning documents). If a U.S. client is advised that one can beat the IRS by simply effectuating such planning outside the U.S., the client should grab his or her wallet first and run (not walk) as fast and as far away from such an advisor as possible. As shown, the asset protection planning component of estate planning can be accomplished while retaining (i) significant control over, (ii) the use of, and (iii) the beneficial enjoyment from the protected assets. The protection afforded is sufficient incentive in and of itself, and the retention of the controls and benefits described generally are inconsistent with the attainment of tax benefits.

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