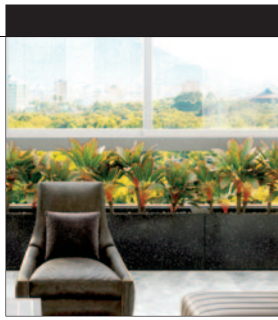

Why Foreign Asset Protection Trusts are Ultimately More Protective than Domestic Asset Protection Trusts

Planning considerations when looking at asset protection options.

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With the various strategies and structures that have been designed and implemented over the past few decades, the asset protection trust (APT) has proven to be one of the most effective barriers to the vagaries of the United States legal system. It is undeniable that the current legal system, coupled with attorneys taking on record numbers of cases on a contingency fee basis, have contributed to the modern era of litigation explosion throughout the United States. For this reason, asset protection planning continues to be of increased importance and value to clients, regardless of their overall net worth. Even though the terms "asset protection trust," "APT," and "asset protection planning" are commonly used, many of these trusts are not solely focused on being "asset protection trusts." Clients may wish to create this type of trust for several reasons other than to protect assets from the client's and/or the beneficiaries' creditors, including, but not limited to: (1) probate avoidance; (2) privacy; (3) dispositive planning; (4) special needs considerations; (5) income, gift, or estate tax savings reasons; or (6) to make charitable contributions. Therefore, the use of the acronym "APT" is being used simply as a reference of convenience and should not be interpreted as suggesting that such trusts are primarily or substantially motivated by asset protection concerns. These types of trusts are designed to comply with Treas. Reg. 301.7701-4 in which a trust under the tax laws must be an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property *for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts*. However, it is important to note that trust ownership of assets may mean that the client relinquishes access to controls and benefits with respect to such transferred assets.

This article provides an introduction to the concept of trusts, APTs, and the reasons why creating (settling) a foreign APT provides an individual with an overall increased level of asset protection compared to settling an APT in one of the twenty domestic states that have currently enacted such legislation (DAPT States).[1]

A trust is an arrangement whereby legal title is bifurcated from beneficial title (also known as equitable title) from certain contributed assets. A trust's settlor is the individual who creates the trust. A beneficiary or beneficiaries refers to the individual(s) for whom the settlor created the trust. Central to the concept of the trust is that of separating legal title from beneficial (equitable) title. Beneficiaries hold equitable title in a trust's assets. The trustee is the individual (or entity) to whom the settlor transfers legal title. Although the trustee holds legal title and is the record owner of the assets, the trustee may not use the trust's assets for his or her individual gain. The trustee under a trust is held to a fiduciary standard and must hold and administer the assets as prescribed by the

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settlor in the trust agreement and as provided for by law.

Although the trustee holds legal title to the trust assets, and the beneficiaries hold the equitable title to the trust's assets, no one actually owns the trust assets outright and for their own benefit, and no one actually owns the trust like some individuals may own a corporation.[2] This is why a trust can be used so successfully for asset protection purposes—neither the settlor nor the beneficiaries own the assets in a fashion that leaves them available to be seized upon by their creditors. The settlor has parted with ownership of the assets, and unless, for instance, they have fraudulently conveyed the assets into the trust, any unforeseen future potential creditors[3] will not be able to access the assets, because generally speaking, creditors can obtain only what the debtor owns, not what the debtor used to own. The trustee, while holding legal title, has no right or claim to benefit under trust assets, so such assets are inaccessible by the trustee's creditors. Moreover, if the trust contains a competently drafted spendthrift provision (described in greater detail below), a beneficiary's creditors should generally not be able to pursue trust assets.

A trust, in general, can often shield the transferred assets from creditors of the trust's non-settlor beneficiaries. Specifically, a spendthrift trust can be created to provide for a beneficiary while also protecting the trust against the beneficiary's poor financial decisions and creditors. It is, in a real sense, a trust set up to protect a beneficiary from spending all the money to which he or she is entitled.[4] A spendthrift provision is simply a provision in a trust document expressly prohibiting beneficiaries from transferring, encumbering, or pledging their respective beneficial interests in the trust. It also typically expressly prohibits any creditor of a beneficiary from attaching, levying against, or seeking a forced sale of the beneficiaries' respective beneficial interests.[5]

When a settlor establishes a spendthrift trust *for the benefit of themself* and others, the trust is categorized as a "self-settled spendthrift trust," which is a standard trust formed for asset protection purposes. The weight of authority is that self-settled spendthrift trusts are indeed valid trusts; however, depending on the applicable law, they may or may not afford protection against the settlor's creditors. If the trust does not afford protection against the settlor's creditors, this would not only apply to the settlor's present or subsequent creditors, but also as to future potential creditors, and for as long as the trust may be in existence. Thus, the "door to trust assets" remains open to creditors with a self-settled spendthrift trust (at least in some jurisdictions), meaning that a judgment creditor would not need to resort to a fraudulent transfer (also known as a voidable transaction) theory or other claim to gain access to trust assets.

An APT involves the repositioning of how a person's assets are owned so that the assets are not as vulnerable to dissipation or confiscation. It is in essence an enhanced estate plan that restructures financial affairs at a time when there are no pending, threatened, or expected creditor claims. This strategic titling of assets is a simple process that can result in those assets being much less susceptible to creditor attachment. The goal that clients like to achieve is to be able to separate ownership from the control and benefits, meaning that although the client would no longer own specified assets, he or she still retains sufficient controls and avenues through which he or she can enjoy the financial benefits of those assets. The characteristics of a trust are particularly well-suited for allowing assets to be owned by a trustee (the legal owner) while the client, as a beneficiary of the trust, continues to hold beneficial (equitable) ownership.

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An APT designed to utilize a favorable foreign jurisdiction's statutes enjoys a well-established history of success that demonstrates a trust can be created that allows a settlor (the client) to be a beneficiary and have the trust assets protected from creditors' claims.[6] As stated above, the very nature of trusts is to allow bifurcated ownership, such that assets are owned under one structure but in two different ways (legal and equitable) simultaneously. For several centuries, families in countries throughout Europe and the United States have used trusts for various reasons, including:

1. asset protection that is provided by favorable spendthrift trust provisions as to the settlor, and as to others, with respect to future potential liability;
2. probate avoidance;
3. confidentiality;
4. a vehicle for global investing;

[1] See Thirteenth ACTEC Comparison of the Domestic Asset Protection Trust Statutes (August 2022).

[2] Many of the trusts of the nature described in this article are grantor trusts, which means that under U.S. federal tax laws, the grantor (settlor) of the trust will be treated as the owner of the trust's assets for U.S. federal income tax purposes. This federal income tax rule should not be confused with the trust law rules regarding the bifurcated ownership of a trustee being treated as the legal owner and the beneficiaries being treated as the beneficial owners. The foregoing applies regardless as to whether the trust is revocable or irrevocable.

[3] This has been the general view by many for years; however, although beyond the scope of this article, remedies may be available to certain "future creditors."

[4] *Black's Law Dictionary* 1400 (6th ed. 1990).

[5] *Estate of Sowers*, 574 P.2d 224, 228 (Kan. App. 1977).

[6] E.g., Nevis, Cook Islands, Isle of Man, Belize.

5. ease in transferring assets;
6. avoidance of potential monetary exchange controls;
7. assistance in the handling of affairs in the event of disability or unavailability;
8. flexibility; and
9. the existence of a protector, which is better established under foreign laws. The protector role helps ensure the trust continues to adapt to changes over time, in line with what the settlor would have desired.

Foreign courts are much more likely to maintain the integrity of protective trust structures created under their laws, as opposed to being swayed by competing public policy considerations, such as spousal rights or duties in a divorce or creditor rights in a bankruptcy.

Settling a foreign APT instead of a domestic APT has many advantages, including:

1. the increased ability of the settlor to retain benefit and control;
2. the foreign APT is less likely to be an automatic target in litigation against the settlor;
3. the foreign element will likely impact a creditor's decision concerning how far to go in pursuing assets; and
4. the foreign element is ultimately more protective. These advantages, and others, are described in more detail below.

The increased ability of the APT's settlor to retain benefit and control

Domestic laws are generally more restrictive regarding how much a settlor can retain in control and benefits with regard to the APT's assets without losing the APT's protective nature. Even if a settlor does not reside in one of the DAPT States that allows for enhanced controls and benefits without losing protection, *foreign* APT laws (in contrast to laws in the United States) are clear that regardless of what state in which the settlor resides, the foreign APT laws enforce the protective barriers of the foreign APT notwithstanding that the settlor retains numerous controls and benefits. Also, foreign APT laws do not carve out special rights for certain exception creditors to be allowed access to assets of an APT in which the settlor is also a beneficiary. In most DAPT States, exception creditors are allowed such access. Even in states such as Nevada that have no exception creditor allowances, there is the example of one court allowing a divorced spouse access to a Nevada APT because the settlor retained too much control (he arguably held a power to make certain amendments to the trust agreement, according to the Utah court presiding over the divorce action).[7] Also, in a California court ruling, the court suggested that transfers to a Nevada APT were per se fraudulent and therefore available to the settlor's creditors.[8]

A foreign APT is less likely to be an automatic target in litigation against the settlor. Domestic APTs remain targets that are within the jurisdiction of United States courts, and as such, are more susceptible to plaintiffs' claims. A properly drafted, implemented, and administered foreign APT is not as likely to be the same automatic defendant in litigation as a domestic APT because a foreign APT is under a legal arrangement with a trustee that is not within the reach of United States jurisdiction. This results in the foreign APT not being subject to United States-based lawsuits, and judgments that follow.

The foreign element will likely impact a creditor's decision concerning how far to go in pursuing assets. The use of foreign jurisdictions creates certain practical barriers that do not exist in pursuits of domestic APTs, several of which are discussed below.

Procedural barriers such as a lack of "comity." In effect, this means the foreign court will give no force or effect to United States proceedings and rulings. An entirely new trial on the merits under the foreign jurisdiction's law may be required to adjudicate the settlor's liability and the APT's liability for the settlor's debt.

For example, Section 13D. of the Cook Islands International Trusts Act 1984, as amended, is entitled "Foreign judgments not enforceable," text shown in Exhibit 1. As an additional example, Section 28 of the Nevis International Exempt Trust Ordinance 1994, as amended in 2015, is also entitled "Foreign judgments not enforceable," with text shown in Exhibit 2.

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[7] See *Dahl v. Dahl*, 459 P.3d 276 (Utah 2015).

[8] See *Kilker v. Stillman*, GO45813 (Cal. Ct. App. Nov. 26, 2012).

[9] See U.S. Const. art. IV, section 1, which states "Full faith and credit shall be given in each state to the public acts, records and judicial proceedings of every other state. And the Congress may by general laws prescribe the manner in which such acts, records, and proceedings shall be proved, and the effect thereof.

[10] Restatement (Second) Conflict of Laws section 93 (1971).

[11] See *Vanderbilt v. Vanderbilt*, 354 U.S. 416 (1957); *Halvey v. Halvey*, 330 U.S. 610 (1947).

[12] Section 13B (entitled "Fraud") of the Cook Islands International Trust Act requires that fraud be proven "beyond a reasonable doubt." Section 24 (entitled "Avoidance of fraud") of the Nevis International Exempt Trust Ordinance also requires proof "beyond a reasonable doubt."

[13] Alabama, Hawaii, Indiana, Michigan, Mississippi, Nevada, Ohio (18 months under certain conditions), South Dakota, Tennessee (18 months under certain conditions), Utah, and Wyoming.

[14] For example, see section 55 of the Nevis International Exempt Trust Ordinance, which currently requires a creditor to deposit a bond in the amount of $100,000 before being able to file a lawsuit against a Nevis trust. No domestic state currently has a bond requirement in effect.

EXHIBIT 1

Section 13D. of the Cook Islands International Trusts Act 1984, as amended, "Foreign judgments not enforceable" Impact of losing a dependent on the parents' 2022 tax return

Notwithstanding the provisions or statute or any rule of law, or equity, to the contrary, no proceedings for or in relation to the enforcement or recognition of a [judgment] obtained in a jurisdiction other than the Cook Islands against any interested party shall be in any way entertained, [recognized] or enforced by any Court in the Cook Islands to the extent that the [judgment]:

(a) is based upon the application of any law inconsistent with the provisions of this Act or of the Trustee Companies Act 1981-2; or

(b) relates to a matter or particular aspect that is governed by the law of the Cook Islands.

EXHIBIT 2

Section 28 of the Nevis International Exempt Trust Ordinance 1994, as amended in 2015, "Foreign judgments not enforceable"

Notwithstanding the provisions of any treaty or convention; the provisions of any statute; any rule of law or equity, to the contrary, no proceedings for or in relation to the enforcement or recognition of a judgment obtained in a jurisdiction other than St. Christopher and Nevis against—

(a) an international trust;

(b) a settlor of an international trust;

(c) a trustee of an international trust;

(d) a protector of an international trust;

(e) a beneficiary of an international trust;

(f) a person appointed or instructed in accordance with the express or implied provisions of an instrument or disposition to exercise a function to undertake any act matter or thing in connection with an international trust; or,

(g) property of either an international trust or of a trustee or a beneficiary thereof; shall be entertained by the Court if—

(i) that judgment is based upon the application of any law inconsistent with the provisions of this Ordinance;

(ii) that judgment relates to a matter or particular aspect that is governed by the laws of St. Christopher and Nevis.

Full Faith and Credit. With domestic APTs, the United States Constitution can be applied to compel one state to give "full faith and credit"[9] to another state's ruling, regardless of how protective the laws of the compelled state may be. Generally, under the Full Faith and Credit Clause, a state court must recognize and enforce a judgment entered by a sister state's court, even if the judgment is at odds with the laws and policies of the state whose court is being asked to enforce the judgment. An exception could apply if enforcement would offend important state public policy.

Most courts have adopted the position stated in Restatement (Second) Conflict of Laws that "[a] valid judgment rendered in one State of the United States must be recognized in a sister State . . ."[10] In other words, even though the court would have come to a different decision under the laws of its state, courts must give deference to a sister state's judgments. Exceptions to this rule have been in the case of a wife's right to alimony, adjudications of child custody, or cases in which a court can lay claim to strong local public policy.[11] As a court sitting in one of the DAPT States could claim that such state has a strong public policy in supporting its own laws, the issue would ultimately need to be decided by the United States Supreme Court. However, most clients who create an APT, whether domestic or foreign, do not plan on spending the time and money to litigate through two state supreme courts and then all the way to the United States Supreme Court.

Heightened burden of proof required by the creditor. The laws of many foreign jurisdictions provide that the burden of proof in challenging (i.e., voiding) asset transfers to an APT is always on the party making the allegations and does not shift that burden to the transferor. Furthermore, foreign APT laws often require a higher threshold before a creditor can establish a basis for challenging the transfer.[12]

Stricter and shorter statute of limitations. Foreign jurisdictions in many cases have a statute of limitations that is shorter (in some cases, non-existent) than the typical statutes of limitations found under American law. Additionally, foreign trust law commonly provides that the statute of limitations for challenging asset transfers to an APT begins to run from the transfer date. Unlike American law, there is no separate statute of limitations that begins to run from the date the transfer is "discovered" by someone with a claim against the transferor. It should be noted, in the interest of full transparency, that with additional states enacting domestic asset protection trust legislation more frequently over the past decade, there are shorter statutes of limitation periods being seen throughout the United States. Eleven of the twenty DAPT States currently have two-year (or less) statutes of limitation,[13] which equals the same length in both the Cook Islands and Nevis (although neither the Cook Islands nor Nevis has a separate statute of limitations that begins to run upon the "discovery" of a claim).

Increased costs. The costs to a plaintiff are usually higher to pursue a foreign APT, especially if the foreign trustee changes the "domicile" of the APT from one foreign country to another during litigation. A creditor may be less willing to incur these higher costs,

especially when one considers that most offshore jurisdictions do not allow for plaintiffs to seek damages on a contingency fee basis (and instead must pay the legal team up front) and (as mentioned above) there may be no comity in the foreign jurisdiction. Foreign courts also many times require a plaintiff to post a bond so that assurances of the payment of anticipated costs will be made in the event the plaintiff loses in the foreign court.[14] Also, punitive damages are most likely not an available remedy offshore.

Unfamiliarity by legal counsel regarding offshore laws. The psychological barriers of dealing with foreign legal systems, added uncertainty of prevailing under foreign law, increased time and geographical factors and the like serve to substantially enhance the protection of an APT's assets should a threat against the settlor one day materialize. It is one thing to obtain a judgment, yet quite another to collect upon it.

Federal preemption. The federal preemption exposure simply refers to the fact that federal law[15] could override protective state laws. For example, under federal bankruptcy law, any transfers to a self-settled trust (i.e., a trust in which the settlor is also a beneficiary) made in the prior ten years can be reversed and made available to creditors if the transfers are considered to have been made with an intent to hinder a creditor (or if a violation of certain securities laws is involved).[16] One may not expect the federal government to be a creditor or federal law to apply, but one never knows for sure. In any event, federal law does not overrule foreign law.

Overall, the trust laws of certain foreign jurisdictions are simply more specific and protective than United States trust law; accordingly, even if a creditor is not dissuaded by the many hurdles erected by a foreign APT, and the plaintiff (via the United States courts) is able to obtain jurisdiction over a foreign trustee, protective foreign statutes make it difficult, if not impossible, to pierce an APT in order to satisfy the settlor's debts. Furthermore, foreign courts are much more likely to maintain the integrity of protective trust structures created under their laws, as opposed to being swayed by competing public policy considerations, such as spousal rights or duties in a divorce or creditor rights in a bankruptcy. For example, in cases in which trusts that apparently were designed to allow a trustee to withhold trust distributions in the trustee's discretion when the beneficiary has creditor problems, United States courts have still viewed the trust assets as being the beneficiary's assets. In contrast, "discretionary" offshore trust designs mean just that: *trust assets are* not *property of the discretionary beneficiary until the trustee voluntarily decides to distribute the property to the beneficiary.* As such, the trust law of, and procedural considerations under, certain foreign jurisdictions are simply more thorough and more protective than domestic trust laws. ■

15 Which may include, but not be limited to, and action involving the Food and Drug Administration, Federal Trade Commission, Federal Deposit Insurance Corporation, the Comprehensive Environmental Response, Compensation, and Liability Act, Bankruptcy Abuse Prevention and Consumer Protection Act, Internal Revenue Service, and/or Securities and Exchange Commission).

16 See 11 U.S.C. section 548(e)(1).