

By Alan R. Eber

The Foreign Trust Tax Solution

THE TOPIC OF FOREIGN TRUSTS CONJURES up alluring images of secret bank accounts in exotic locations far from the prying eyes of the Internal Revenue Service. However, a U.S. tax-compliant offshore strategy is completely legal and can provide unparalleled asset protection while also reducing income and estate taxes. Wealthy individuals have used compliant offshore tax planning for years, and more recently these techniques have become available to those of more modest means. Although a foreign trust can save taxes through legitimate strategies, protect assets, and provide privacy, there are a number of pitfalls that the professional needs to consider.

The offshore asset protection and tax havens exist because of a powerful demand by individuals in many countries to shelter their wealth from a variety of perceived threats. In the U.S. these threats are often the product of a legal system that unfairly targets those with wealth. In other countries with fewer lawyers and lawsuits, the threat of litigation is not the primary concern. Instead, asset protection and privacy issues are related to the political and economic climate that poses risks to an individual's life and livelihood, such as kidnapping, confiscation, exchange controls, and so forth.

A Foreign Asset Protection Trust (FAPT) is a discretionary irrevocable trust that is set up in a country other than the United States and that contains sophisticated drafting and, sometimes, tax planning to protect its assets. Proper drafting can endow the FAPT with the ability to take advantage of choices offered by using the laws of various countries, always with an eye on emerging international standards.

United States tax structuring can pro-



vide the FAPT with the ability to legally take advantage of benefits offered in the Internal Revenue Code and Treasury Regulations—advantages not available to the domestic-only planner. Although it is almost universally understood that because of IRC §672-679, the foreign trust is a grantor trust and is therefore tax-neutral, to the professional advisor, this may not be exactly the case.

Making FAPTs Less Foreign

Let's review the history and structure of trusts, especially FAPTs.

Trusts were first formed centuries ago when members of monastic orders, having taken vows of poverty, were embarrassed by their huge land holdings. To resolve their moral problem, they asked the king to hold and own the land or take "legal title" for their benefit, which was called an equitable interest. The king was the trustee and the monks were the beneficiaries.

All foreign trusts transfer legal title to a trustee, generally a trust company, whose business is operated (OR DOMICILED?) outside the U.S. The person setting up the trust is the settlor or grantor. The trust is

Foreign asset protection trusts can legally ease some clients' tax burdens

created in the form of a legal document—a deed of trust or trust deed. The protector is a person, appointed under the trust, with whom the trustee may consult when administering the trust and who has the power to negate actions the trustee may want to pursue. The protector, who can be a foreign or U.S. person, including a best friend (OF THE GRANTOR?), can be authorized to remove trustees and appoint non-U.S. trustees.

The trustee is a fiduciary who is governed by stringent rules to act in the best interests of the beneficiaries and can be discharged by the protector. Assets may be held by financial institutions, which could be required to sign off on any asset transfer, and are insured. All persons with possible access to trust assets can be bonded.

The letter of wishes or, in cases where privacy is paramount, a memoir to the attorney, is an informal and confidential letter from the settlor that provides guidance as to how the trustee might exercise his discretion. Included in the trustee's discretion is the power to accumulate or distribute income among a specified class of beneficiaries. The letter of wishes is not part of the trust and can be amended.

The trustee holds trust property in accordance with the obligations imposed by the trust deed and administers trust assets. Beneficiaries can be named specifically or generally as members of a class

(e.g., “my descendants”), and beneficiaries have recourse under the law to compel the trustee to act according to the terms in the trust deed.

With an FAPT, the settlor is in control. While the FAPT gives the trustee discretion to make decisions, the letter of wishes suggests how the trustee should exercise that discretion. The settlor appoints a protector with power to enforce the letter of wishes. If the settlor dies, the FAPT can, if so drafted, act like an asset protected living trust.

During the grantor’s life, the FAPT is income tax-neutral, though not necessarily estate tax-neutral. However, an FAPT loses its grantor trust status at the grantor’s death—since the grantor is dead, there is no grantor to tax—and the grantor’s estate will not be treated as owner of the trust assets. On death, the grantor trust becomes a Foreign Non-Grantor Trust (FNGT) and its income is taxed by the country in which it is located. The U.S. can only tax distributions that the trust makes to U.S. taxpayers. If the FNGT is situated in a zero-tax jurisdiction, its assets will grow tax-free.

If FNGT assets are distributed to U.S. beneficiaries, they may or may not be taxed, depending on how the FAPT was structured. If not structured for tax benefits—and the vast majority of FAPTs are not—after the death of the settlor a non-deductible interest charge will be applied to the tax attributable to a distribution multiplied by the number of years the distribution was accumulated in the FNGT. Throwback rules will affect the tax as well. The purpose of the throwback rules is to prevent avoidance of U.S. income taxes through the accumulation of income taxed at lower rates than the beneficiary would have paid if the income had been distributed. The tax and interest due may quickly reach 100% of the distribution.

The planning potentials for an FAPT are significant. Beneficiaries are exempt from the receipt of a “specific sum of money,” **according to the IRC? , OR IS THIS THE WORDING OF THE TRUST DOCUMENT? .** This requirement is met if the distribution is not paid only from current or accumulated income, and is paid in three or fewer installments. On a yet more sophisticated level, consider structuring

The letter of wishes suggests how the trustee should exercise the discretion granted under the FAPT.

distributions of accumulated income as a specific sum of money via an entity. For example: “Bequests to decedent’s son of decedent’s interest in a partnership...are bequests of specific property...” Regulations require the amount of money or identity of property to be “ascertainable,” not “known;” e.g., a bequest of a partnership interest is a specific bequest of ascertainable property, although the value of the interest may in fact be different on the date of distribution than on the date of death. **AGAIN, ARE THESE QUOTES FROM THE IRC OR SAMPLE WORDING OF THE TRUST DOCUMENT? .**

Foreign Advantages

Foreign asset protection trusts have many other advantages as well. For instance, one of the best is that the FAPT is established under laws of a foreign country that may be more favorable to asset protection and privacy objectives than U.S. laws. Another advantage is that some countries provide for a short statute of limitations on fraudulent conveyances. Most states, such as California, have four-year statutes, so a creditor can attack asset transfers up to four years after they took place. In short-statute jurisdictions that exist in a number of favorable trust locations, a creditor attack can only take place during a limited time after the transfer occurs.

Another benefit is that some jurisdictions require the difficult “beyond a reasonable doubt,” rather than the lesser “preponderance of the evidence” standard to prove fraudulent conveyance. It behooves the professional to determine which jurisdiction is most advantageous to a particular client’s situation.

Some foreign courts will not enforce a judgment rendered in the U.S. To prosecute a claim, the creditor would have to go to that country and retry the case, which

provides the trust with added protection. Another advantage is that U.S. courts have no capacity to exercise authority over a foreign person who has no presence or assets in the U.S. If a U.S. court ordered a foreign trustee to return assets, the trustee who is responsible for preserving trust property would refuse to comply.

In addition, FAPTs allow the settlor to be a beneficiary, permitting settlors to retain a degree of enjoyment over trust assets that would not be permitted in most states. In those states that protect self-settled trusts, there is as yet no judicial authority as to the degree of protection they afford, and in federal matters such as bankruptcy, federal law most likely would preempt state law.

Oftentimes, clients want to know if FAPTs are truly creditor-proof. If a settlor retains control over the appointment of the trustee, or if domestic trust protectors have the power to remove and replace the trustee, and if the trust does not specifically prohibit the settlor or protector from appointing a U.S. trustee, a U.S. court may require these parties to appoint a U.S. trustee. If they refuse to obey, the judge can hold them in contempt. Once the trustees are under the court’s jurisdiction, the court can require them to repatriate assets. An FAPT will be most effective if the settlor relinquishes direct control over the trust and its trustees.

When creditors or litigants come forward after the client has set up the foreign asset protection trust, they can only obtain assets that belong to the client. However, since, assets in an FAPT no longer belong to the client, the creditors or litigants might try to set the transfer aside as fraudulent. This could be frustrated under U.S. law by the passage of time (in California it would be four years, for example), and if not frustrated by domestic law, the credi-



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tor or litigant would still have to prevail under the laws of the FAPT jurisdiction, which are often onerous to creditors.

Even though the client complies with all court orders, the trustee would properly not heed directives issued by a client under duress, which is the initiation or threatened initiation of legal action against the settlor, the FAPT, any of the trust's assets, or the trustee. Trustees act to protect the interests of the beneficiaries and U.S. courts do not have jurisdiction over the trustee. An attempt to bring action against the FAPT in the foreign jurisdiction that makes some headway would cause it to be moved to another jurisdiction. A litigant is likely to seek settlement, since the cost of pursuing an FAPT in general or an FAPT as it moves to different jurisdictions is often prohibitive.

A U.S. judge can order a client to return assets and back these orders with a contempt charge if clients fail to comply. A major issue is often ability to return transferred property pursuant to court order. FAPT agreements require the trustee to disregard communications issued under duress. As a result, the settlor has no right to reacquire trust assets. Unless the settlor retains certain powers or the trust is poorly drafted, a court cannot compel an action that an individual has no power to perform. A foreign trustee will often not respond to orders from a court outside of its jurisdiction.

The result may be different when an FAPT is used to defraud creditors or the IRS or to protect the proceeds of criminal or fraudulent activities. A judge may ignore provisions of the trust and apply the leverage of a contempt order. The FAPT is not designed to allow individuals to defraud others or engage in tax evasion or criminal conduct.

Clients want protection against future creditors and unscrupulous predators. The foreign asset protection trust may in many cases provide the ideal defense. 

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