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## **Asset Protection Trusts – The Creditor’s Nightmare**

**By Alexander A. Bove, Jr.**

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It is said that every ten seconds a lawsuit is filed somewhere in the United States. There are more lawyers in Southern California than in the entire country of Japan. It’s no wonder that most of our clients ask about trusts for asset protection. When that is the objective, exactly what kinds of trusts will work best to protect the client’s assets?

### **Don’t All Trusts Protect Assets?**

Most clients believe that any trust will protect assets, but that is simply not so. Asset protection trusts must be drafted in a very particular way, funded on a timely basis, and, in many cases, administered in very particular jurisdictions. In this context and in this discussion we are talking about a trust created by a person *for his own benefit*. Of course, other individuals, such as the person’s spouse and children, may also be beneficiaries, but the main objective here is an arrangement where the person can “have his (financial) cake and eat it too.” For instance, Gordon creates an irrevocable (as it must be) trust naming himself as primary beneficiary but providing that distributions may also be made to his wife and children. Any and all distributions,

however, are to be made only at the sole discretion of the trustee. That is to say, Gordon has no ability to force the trustee to make distributions.

This is what is known as a “self-settled spendthrift trust.” That is, the trust is “settled” or created by Gordon himself for his own benefit. (Gordon would be the “settlor”.) In 43 states, such a trust will offer no protection whatsoever against Gordon’s creditors. This is because the general rule of law for such trusts is that the settlor’s creditors can “reach” into the trust and be paid the most that Gordon could be paid under the terms of the trust, *even though* Gordon himself could not do so.

### **There’s No Place Like Home? Domestic Asset Protection Trusts**

In seven states, and in several foreign jurisdictions, there are laws which are just the opposite. Those laws provide that creditors of the settlor of a self-settled spendthrift trust may *not* reach the assets in that trust unless the creditor can prove that the transfer of assets to the trust was a “fraudulent transfer.” Briefly, and I really mean briefly, a fraudulent transfer is one designed to unfairly prevent creditors from reaching the transferred asset, “unfairly” being the key word. In practical and basic terms, it means that if you are aware of any claim against you that is *pending, threatened, or expected*, any transfer you make where you do not receive something of equal value in return will likely be considered a fraudulent transfer.

For instance, you are in the midst of a business deal that you can see is going sour, and when it does, you will be liable for a substantial sum. Months before the end of the deal, you make a gift of most of your available assets to your husband as part of an “estate plan.” Unless you have adequate assets remaining to cover the anticipated liability, you have made a fraudulent transfer.

The consequence of a fraudulent transfer is not that a crime has been committed, but rather that it was unfair to your creditors, and if you do not have other funds or assets to cover your debts, a court can, among other things, order a return of those assets that were “fraudulently” transferred. *Note* that this could be the case even though the debt was not due when you made the transfer, or

no claim had been made, or where you disputed the claim, believing you didn't owe it or weren't liable for it.

The seven states that allow self-settled spendthrift trusts are (as of this writing) Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, and Utah. In general, their laws are roughly the same, providing that:

- The trust must be irrevocable,
- The trustee (or at least one of the trustees) be resident in the subject state,
- The trust states that it is governed by the law of the state,
- The transfer to the trust was not a fraudulent transfer,
- The trust contains a “spendthrift” provision (i.e., a statement that a beneficiary's share or interest may not be transferred by the beneficiary or reachable by his or her creditors), and
- Trust distributions to the settlor are fully discretionary.

There are other provisions and slight differences among the states' laws, but these are the core requirements. The big question is, will they stand up to a creditor's attack? A fair amount of commentary has been written about this, centering for the most part around constitutional issues. Think about it: A person in New York establishes (and funds) an asset protection trust in Delaware. A few years later, the New Yorker is sued (in New York, or any other state) on a debt that arose well after the creation of the Delaware trust, and the creditor obtains a judgment against the New Yorker. The New Yorker has insufficient funds to pay, so the creditor sues the Delaware trustee, asking the court to enforce the judgment based on the full faith and credit clause of the U.S. Constitution. That clause provides: “Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State.”<sup>1</sup>

But the clause refers to the enforcement of a judgment against the *same* defendant, not against someone else. Here, the judgment was against the New Yorker, not the trustee of the Delaware trust. What about the fact that the trust contains the New Yorker's property? Why shouldn't that property be subject to the judgment? Such reasoning would apply were it not for the fact that

once the property has been transferred to the trust, and absent a fraudulent transfer, the property no longer belongs to the New Yorker, it belongs to the trustee to be held for the trust beneficiaries, and Delaware law expressly states that the assets in such a trust will not be reachable by creditors of any beneficiary, including the settlor.

Another argument in favor of the creditor is the “public policy” and conflict of law argument, based on the conflict of New York law with Delaware law. That is, if it is against New York law to protect assets with a self-settled spendthrift trust, why should a New Yorker be able to avoid his legal debts (and New York law) simply by moving his money and investments to a Delaware trust? In fact, in at least one New York case dealing with this very issue (though a foreign trust was involved), the court disregarded the foreign trust and held that New York law applied.<sup>2</sup> The only problem was, and would be in our example, that the money was not in New York, and the New York judgment could not be enforced against the foreign trustee who held the money in the foreign jurisdiction (as would likely be the case in our example). Accordingly, even with a judgment, the creditor in such a case is left holding the (empty) bag.

There are additional arguments, pro and con, but there are as yet no cases resolving the question, and the consensus is that it will take a very long time and be a very expensive battle for the creditor who seeks to bust the trust, with no assurance that he will be successful. The natural effect of such a predicament is to induce a willingness on the part of the creditor to settle the claim, which is one important objective of asset protection planning.

### **Somewhere, Across the Sea?**

If a domestic asset protection trust (“DAPT”) as described above has a good chance of protecting assets, why would anyone need or want an offshore (non-U.S.) trust? First, as pointed out, no one can say for sure whether a DAPT will protect the settlor’s assets if put to the test, and there are noteworthy arguments against it.<sup>3</sup> Second, the trust assets are here in the U.S. and subject to the jurisdiction of U.S. courts, including in some cases, federal courts, which could decide to apply federal law, rather than the state law of the trust.<sup>4</sup> It is well accepted in the asset protection planning community that the ultimate asset protection plan is through an offshore trust. For

openers, a huge advantage of the offshore trust (in the right location) is that they are not under the jurisdiction of any U.S. court, so a U.S. court judgment against the settlor or even against the trust itself is meaningless as to the trust, since the judgment cannot be enforced in the foreign jurisdiction. A second advantage, unmatched under U.S. law, is the fraudulent transfer rules. If a creditor becomes a creditor after the settlor has established the offshore trust, he is simply out of luck, because typical offshore laws give “future” creditors of the settlor no rights over the trust. Compare that to U.S. laws, where future creditors have four years after the trust creation to sue (ten years if the settlor files for bankruptcy).

Under U.S. law, creditors who have claims that exist at the time the settlor creates the trust are given considerably greater leeway to enforce their claims than future creditors. Existing creditors may make a claim against a DAPT *within the greater of* four years from the creation of the trust or one year after the creditor could reasonably have discovered the existence of the trust. Thus, if a protracted lawsuit is involved, it could stretch the period of limitations to six or eight or ten years! In fact, there is no specified time limit. Contrast this with an offshore trust where existing creditors, as a general rule, have only two years (this varies somewhat in the different jurisdictions) after which they are summarily shut out. (Note that creditors may not even learn of the existence of the offshore trust until after the two year time period.) And the kicker is that the creditor must bring the lawsuit *in* the offshore jurisdiction. Furthermore, attorneys outside the U.S. do not work on contingent fees, so legal fees must be paid as incurred. Still another financial hurdle: some jurisdictions require the creditor (plaintiff) to post a cash bond with the court of up to ten percent of the amount sought in the lawsuit. Lastly, if the foregoing isn’t enough, in the more popular offshore jurisdictions the burden of proof at the foreign trial is on the creditor to prove *beyond a reasonable doubt* that the settlor’s transfer to the offshore trust was made for the purpose and with the intent to avoid payment to *that particular creditor*. In the U.S., the burden is met by the much more liberal rule of a “preponderance of the evidence,” *and* it is met if it applies to *any* creditor, not just the creditor who brought the suit.

From the standpoint of getting money out of the trust for the settlor and his family, the offshore trust and the DAPT work much the same. The trust should be fully discretionary, meaning that the trustee, typically a bank (with trustee powers) or a trust company, will decide on its own

what to distribute (income, principal, or both), how much, when, and to whom. As a practical matter, however, the trustee will have an idea what the settlor and his family may “need” from the trust, but keep in mind the idea is to protect the money/investments, so the more that is left in the trust, the greater amount protected. If trouble is on the horizon or worse, distributions can be made to a spouse, or directly to a third party to satisfy the settlor’s (or family) expenses, such as mortgage or tax payments, utilities, etc., so the funds do not pass through the settlor’s hands. And in the future, depending on the settlor’s circumstances and exposure to liability, it is even possible to terminate the trust and return the funds to the settlor, although this is not the typical objective and must be planned very carefully.

### **Who Handles the Investments?**

When preparing and advising on offshore trusts, I am often asked whether the investments must be moved offshore along with the trust. My preliminary response is that complete protection can only be achieved if the investments themselves are beyond a U.S. court’s jurisdiction.

Frequently, however, the client has an established relationship with his U.S. investment advisor and prefers not to change. (No need to comment on the advisor’s position on this.) The value of such a relationship is easy to see, and in such cases we can structure the plan so that the investments can continue to be held and managed by the client’s domestic advisor but nevertheless enjoy almost the same degree of protection by having the advisor manage the funds held locally by a foreign entity. Such an arrangement satisfies the client and the advisor, but we make it clear to both of them that if a lawsuit was to appear on the horizon, it would be wise to move the investments out of harm’s way. It should be noted that in many cases it is possible for an advisor to continue to manage an investment portfolio that is custodied in another jurisdiction.

Even though offshore asset protection trusts must be irrevocable as to the settlor, they can be and typically are drafted to have great flexibility, allowing changes to be made to the trust, including the addition or deletion of beneficiaries, changing the trustee or the trust’s location, and other things, without effecting its protective integrity. Such provisions, however, must be coordinated with the settlor’s estate plan, as the offshore trust is often an integral part of that plan. In many, if not most instances, the flexibility is realized through the appointment of a “protector” to the

trust. A protector is an individual (though it could be more than one person or even an entity) who holds powers over the trust (such as the power to amend the trust or remove the trustee) but who is not a trustee and typically not a beneficiary. And with offshore trusts the protector should not be a U.S. person, since we do not want him or her to be subject to a U.S. Court order.<sup>5</sup>

### **Taxes and Reporting**

The good news is that both domestic and offshore asset protection trusts are tax neutral for income tax purposes. That is to say, they are both considered “pass-through” entities, so that all income, deductions, and losses pass directly through to the settlor.<sup>6</sup> For gift tax purposes, virtually all such trusts contain a provision giving the settlor the power to “appoint” (i.e., direct the distribution) of the remaining trust assets at her death. This provision prevents the transfer to the trust from being a taxable gift.<sup>7</sup> As to estate taxes, both the retained power of appointment just mentioned and the fact that the settlor is a beneficiary of the trust cause the full trust value to be included in the settlor’s estate for estate tax purposes.<sup>8</sup> A number of commentators believe that it is possible to establish such a trust so that the proceeds would be excluded from the settlor’s estate, even though the settlor may be a discretionary beneficiary, by foregoing the reserved power to appoint and any other measure of control.

One of the biggest differences between the DAPT and the offshore trust is the tax reporting requirements. In 1996, a new tax code section was adopted,<sup>9</sup> requiring the filing of certain forms with respect to the creation of, transfers to, and distributions from a foreign trust, as well as annual reports by the offshore trustee. Shortly after the law was enacted, the IRS issued Revenue Procedure 97-34 detailing the reporting requirements. Understanding and following the reporting requirements for foreign trusts are particularly important, because the penalty imposed for failure to comply is 35 percent of the amount transferred to the trust (on creation, transfers, and distributions) and an additional five percent for failure to file the trustee’s annual report. Other forms are required as well, and although these requirements add a cost to the annual administration of the trust, such costs are not prohibitive and may be viewed as part of the asset protection “insurance premium.” And speaking of costs, the trustee fees for administering an

offshore trust are competitive with (and sometimes much less than) trustee fees for domestic asset protection trusts.

### **Where Should We Go for Our Trust? Delaware? Cayman Islands? North to Alaska? Or What?**

Once you have decided on an asset protection trust, where should it be located, or in trust terms, “situated?” If it is decided to establish a DAPT, although all of those states’ laws are very similar, Delaware has so far been the most common choice. One reason is that since its adoption of the law in 1997, Delaware has been continually reviewing and updating its law, and it is felt among practitioners that Delaware’s attention towards and experience with the DAPT makes it a sensible first choice.

If, instead, more serious protection is desired, an appropriate offshore jurisdiction must be chosen, but for the ‘inexperienced’ advisor, this can be a formidable and very time-consuming task, since we are often offered questionable advice and sometimes caught by popular misconceptions. For example, who doesn’t associate the Cayman Islands with offshore transactions, including trusts? In point of fact, the Caymans is regarded as one of the worst choices for asset protection trusts, having a six year statute of limitations (to attack the trust) and a mechanism for allowing recognition of U.S. judgments, thus scoring a zero on the two most critical criteria.

Speaking of criteria, there are many to review when choosing a foreign jurisdiction for a client’s asset protection trust,<sup>10</sup> but by far, the two just noted are the most important. This is not to say that they are always controlling. Close to them in importance are the stability and integrity of the jurisdiction and its experience with cases where such a trust has been attacked. For instance, although Gibraltar has a longer period of limitations (six years), before a creditor can even initiate a suit against a Gibraltar protective trust he must *prove* to the court that the settlor’s transfer to the trust rendered him (the settlor) insolvent. Similarly, in the Isle of Man, a creditor whose claim arose any time after the establishment of the trust will have no standing to reach the trust assets. And the Cook Islands, which has an outstanding and respected judiciary and

extensive experience in applying its asset protection trust legislation, precludes any attack against a trust established there except for existing creditors (at the time of the trust's creation) who bring suit against the settlor within one year of the trust settlement *and* who can prove that the settlement rendered the settlor insolvent. If the creditor meets those criteria, he must then prove, *beyond a reasonable doubt*, in a Cook Islands court, that the settlor made the transfer with the intention to avoid paying *that particular creditor*.

In short, for these types of reasons and after considering dozens of jurisdictions worldwide, it is my observation that the more commonly chosen offshore jurisdictions for asset protection purposes by experienced advisors are the Cook Islands, Gibraltar, the Isle of Man, and Liechtenstein.

## **Conclusion**

This discussion has presented an overview of asset protection trusts touching upon what I feel are the most important points. The subject is far broader than could be covered here, as evidenced by the fact that each of the three leading resources on the subject are volumes of length.<sup>11</sup> Accordingly, after advisors have familiarized themselves with the issues involved, decided that some asset protection planning is appropriate, and narrowed the client's choices, the assistance of an expert in the field is the logical and necessary next step.

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<sup>1</sup> U.S. Const. Art. IV, § 1.

<sup>2</sup> *In re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996).

<sup>3</sup> Duncan E. Osborne and Leslie G. Giordani, *Will the Alaska Trust Work?* Journal of Asset Protection, Vol. 3 No. 1, at 7 (September/October 1997).

<sup>4</sup> *Id* at page 12.

<sup>5</sup> Alexander A. Bove, Jr., *Trust Protectors – Are they friends or fiduciaries? And should every trust have one?* Trusts & Estates, November 2005.

<sup>6</sup> For the DAPT, it is IRC §677 that causes the pass through; for the offshore trust, it is IRC §679.

<sup>7</sup> Treasury Regulation §25.2511-2(c).

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<sup>8</sup> IRC §2036 and §2038, although some commentators argue that §2036 (the retained benefit section) should not apply if the trust is truly discretionary and there is no agreement to pay the settlor any particular amounts.

<sup>9</sup> IRC §6048

<sup>10</sup> Alexander A. Bove, Jr., *The Mechanics of Establishing an Offshore Trust*, Chapter 5, *Asset Protection Strategies – Planning with Domestic and Offshore Entities*, Vol. 1 (Alexander A. Bove, Jr. ed., American Bar Association 2002).

<sup>11</sup> See, e.g., *Asset Protection, Domestic and International Law and Tactics* (Duncan Osborne, ed., Clark Boardman Callaghan, 1996); *Asset Protection Strategies – Planning with Domestic and Offshore Entities, Vol. I and Vol. II* (Alexander A. Bove, Jr., ed., 2002, 2005, American Bar Association); Peter Spero, *Asset Protection: Legal Planning and Strategies* (Warren, Gorham and Lamont, 1994).