OFFSHORE TRUSTS AND RELATED ASSET PROTECTION STRATEGIES FOR REAL ESTATE OWNERSHIP

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"Family Limited Partnerships, Offshore Trusts and Other Wealth Planning Alternatives", Business and Estate Planning; University of Houston Law Foundation; 1997 and 1998.

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I. INTRODUCTION

The use of offshore trusts to legitimately maximize the protection of a client's personal wealth has gained new recognition and acceptance in today's litigious society. Now, more than ever, any business or estate plan requires an examination of the risk associated with the client's activities and business holdings. Attorneys and other professionals must consider the benefits, goals, issues and risks involved in establishing an offshore trust as part of a comprehensive asset preservation plan for the wealthy client, business owner or executive with significant business holdings or investments. The benefits of an offshore trust are all too obvious in those situations when a client without an offshore trust, but with substantial assets at risk, becomes a defendant in a serious lawsuit. If such a client has not already protected his or her assets with an offshore trust, the client could face financial ruin.

Unfortunately, many clients and their lawyers never consider the benefits of an offshore asset protection trust until it is too late. Attorneys should be prepared to adequately advise the client at risk about the benefits of an offshore trust. The businessman turned defendant by a major lawsuit is unlikely to question the merits or moral significance of protecting one's assets with a professionally established offshore trust. If he has not already protected his personal assets with a trust prior to the threat of litigation arising, the client is more likely to ask why his lawyer did not advise him to at least investigate the merits of using an offshore trust to protect his personal assets. In fact, it is this author's belief that failure to so advise a wealthy or at risk client may constitute malpractice if the client's assets are needlessly exposed to a subsequent judgment or other legal claim.

This paper will focus primarily on the proper use of an offshore trust for legitimate asset protection purposes. However, an extensive discussion of the applicable bankruptcy, fraudulent conveyance, money laundering and other civil and criminal pitfalls for clients and their attorneys will also be addressed.

Reasons for Going Offshore? Although there are many advantages of going offshore to seek asset protection, there are two principal reasons for doing so. First, by utilizing the law of a foreign jurisdiction, the client can utilize the best law available to fulfill the client's goals of effective but legal asset protection. Many offshore jurisdictions have adopted legislation which is specifically designed to offer the maximum amount of protection to the settlor and the assets transferred to a trust by the settlor. This is true even when the settlor is the primary beneficiary of the trust, an option that is generally not available in the United States. Secondly, Americans seek the benefits of an offshore trust to protect assets from the risk associated with having such assets within the jurisdiction of U.S. courts during the pendency of litigation or while a judgment is outstanding.

Who Should Go Offshore? An offshore asset protection trust is not for everyone. However, an offshore asset protection trust should be considered by any individual or family who has liquidity in excess of $500,000 to protect. This is particularly true for individuals in high risk professions such as attorneys, doctors, engineers and businessmen, particularly businessmen who are affiliated with publicly held companies. Litigation in these professions is a fact of life that must be anticipated and planned for.

Use of Family Limited Partnerships. In many circumstances, it is preferable to transfer most if not all of assets to be protected to a family limited partnership or limited liability company that will be substantially owned by an offshore trust but managed by the settlor in his or her capacity as general partner or manager of the entity. As will be discussed below, such an arrangement allows the settlor to continue to manage protected assets while at the same time effectively transferring virtually all of the ownership interest in those assets to the offshore trust.

When NOT To Go Offshore. Just as offshore asset protection planning is an important consideration in advising a client, it is just as important to note what asset protection planning is not. Specifically, **asset protection planning is not an excuse to defraud existing creditors**. The concepts that will be discussed in this paper are designed to apply to situations where a client wishes to protect his/her assets from the claims of future creditors. Use of the techniques described in this paper in an attempt to or as part of a scheme to defraud existing creditors will, in most cases, fail outright, and in the worst case, result in potential criminal liability to the client and possibly his attorney.

II. TRADITIONAL FORMS OF ASSET PROTECTION PLANNING

A. Exemption Planning. Texas has long been known as a "debtor haven" throughout the United States. This classification is based upon the liberal property exemptions found in the Texas Property Code. The Code itemizes real and personal property which is exempt from attachment by creditors. Section 522 of the federal Bankruptcy Code also provides a detailed outline of assets exempt from creditors in bankruptcy proceedings. However, the Bankruptcy Code also provides that a debtor in bankruptcy may avail him or herself of either the federal exemptions offered under the federal bankruptcy law or exemptions offered under state law. Because state exemption laws are far more generous than the exemptions offered under federal bankruptcy law, it is customary in Texas that a debtor will rely on the exemptions offered by the Texas Property Code to protect his or her assets from creditors.

1. Real Property. A homestead and one or more lots used for a place of burial of the dead are exempt from seizure for the claims of creditors except for encumbrances properly fixed on homestead property. TEX. PROP. CODE ANN. §41.001. If used for the purposes of an urban home or as a place to exercise a calling or business in the same urban area, the homestead of a family or a single, adult person, not otherwise entitled to a homestead, shall consist of not more than one acre of land which may be in one or more lots, together with any improvements thereon. TEX. PROP. CODE ANN. §41.002(a). If used for the purposes of a rural home, the homestead shall consist of:

a) for a family, not more than 200 acres, which may be in one or more parcels, with the improvements thereon; or

b) for a single, adult person, not otherwise entitled to a homestead, not more than 100 acres, which may be in one or more parcels, with the improvements thereon.

2. **Personal Property**. The exemptions for personal property are found in Chapter 42 of the Texas Property Code. Personal property, as described in §42.002 of the Code, is exempt from garnishment, attachment, execution, or other seizure if:

a) the property is provided for a family and has an aggregate fair market value of not more than $60,000, exclusive of the amount of any liens, security interest, or other charges encumbering the property; or

b) the property is owned by a single adult, who is not a member of a family, and has an aggregate fair market value of not more than $30,000, exclusive of the amount of any liens, security interest, or other charges encumbering the property.

Section 42.001(b) provides that the following personal property is exempt from seizure and is not included in the aggregate $60,000 or $30,000 limitations prescribed by subsection 42.001(a):

(a) current wages for personal services, except for the enforcement of court ordered child support payments;

(b) professionally prescribed health aids of a debtor or a dependent of a debtor.

The personal property exemptions provided by Chapter 42 of the Texas Property Code do not prevent seizure by a secured creditor with a contractual landlord's lien or other security in the property to be seized. TEX. PROP. CODE ANN. §42.001(c). Unpaid commissions for personal services not to exceed 25 percent of the aggregate limitations prescribed by subsection 42.001(a) are also exempt from seizure but are included in the aggregate.

3. **Retirement Plans—State Exemption**. The 70th Legislature extended the exemption protections of the Texas Property Code to retirement plans by adding §42.0021 of the Texas Property Code effective September 1, 1987. The provision has been amended several times and was last amended effective August 28, 1995.

a. **Retirement Plans Protected**. Section 42.0021 of the Code provides that, in addition to the exemption prescribed by Section 42.001, a person's right to the assets held in or to receive payments, whether vested or not, under any stock bonus, pension, profit-sharing, or similar plan, including a retirement plan for self-employed individuals, and under any annuity or similar contract purchased with assets distributed from that type of plan, and under any retirement annuity or account described by Section 403(b) of the Internal Revenue Code of 1986,[1] and under any individual retirement account or any individual retirement annuity, including a simplified employee pension plan, is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract, or account does not qualify under the applicable provisions of the Internal Revenue Code of 1986.[2] A person's right to the assets held in or to receive payments, whether vested or not, under a government or church plan or contract is also exempt unless the plan or contract does not qualify under the definition of a government or church plan under the provisions of the federal Employee Retirement Income Security Act of 1974.[3] To the extent the foregoing state exemptions are held invalid or preempted by federal law in whole or in part or in certain circumstances, the state exemptions remain in effect in all other respects to the maximum extent permitted by law. Contributions to an individual retirement account or annuity that exceed the amounts deductible under the applicable provisions of the Internal Revenue Code of 1986 and any accrued earnings on such contributions are not exempt under Section 42.001 unless otherwise exempt by law.

4. **ERISA Protection of Retirement Plans**. The Employment Retirement Income Security Act of 1994 (ERISA) is designed to provide federal tax treatment for employee retirement plans and to protect those plans against the claims of creditors of plan participants. The "anti-alienation" provisions are found in 29 U.S.C. §1056(d)(1) and provide that "each pension plan shall provide that benefits provided under the plan may not be assigned or alienated." The purpose of the proscription on alienation and assignment contained in the foregoing section is designed to protect an employee from his own financial improvidence in dealings with third parties, and is intended to assure that the employee and his beneficiaries will reap the ultimate benefits due on retirement. American Telephone & Telegraph Co. v. Mary, C.A. Conn. 1979, 592 F.2d 118.

The Bankruptcy Code excludes from the "bankruptcy estate" property of the debtor that is subject to a restriction on transfer enforceable under "applicable non-bankruptcy law." 11 U.S.C. §541(c)(2). In the Supreme Court case of Patterson v. Shumate, the Supreme Court held that the anti-alienation provisions contained in an ERISA-qualified pension plan constituted a restriction on transfer enforceable under "applicable non-bankruptcy law," and thus, the debtor could exclude his interest in such a plan from the property of the bankruptcy estate.

B. **Domestic Trust**. The domestic trust has been successfully utilized by practitioners as a crucial estate planning and asset protection planning tool for decades. Despite restrictions on the ability

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1 26 U.S.C.A. §403(b)

2 26 U.S.C.A. §1 et seq.

3 26 U.S.C.A. §1001 et seq.

of a settlor to retain an interest in a trust, a properly structured irrevocable trust, where the grantor has "cut the strings" in terms of benefit and control, has been, and still can be successfully used to preserve the assets of the grantor for the benefit of his family.

1. **Spendthrift Trust**. One of the most common types of trust used in asset preservation is the spendthrift trust. A spendthrift trust is one which provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The legality of spendthrift trust is recognized in Chapter 112.035 of the Texas Trust Code which provides that a settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. TEX. TRUST CODE §112.035. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary to the maximum extent permitted by §112.035 of the Texas Trust Code.

2. **Discretionary Trust**. A discretionary spendthrift trust provides even greater protection to its beneficiaries than a regular spendthrift trust. In a discretionary trust, the trustee has sole and absolute "*discretion*" to decide the amount and the timing of income or principal distributions to the beneficiary. Typically, as long as property is held in trust and is subject to the terms of a spendthrift provision, the general rule is that property may not be reached by the creditors of a beneficiary of that trust. However, once the proceeds are distributed to the beneficiaries, they escape the protection of the clause and may be reached by creditors. First Northwestern Trust Co. v. IRS, 622 F.2d 387 (1990). However, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity from judicial process. First Northwestern Trust Co. v. IRS, *infra* at 391. Although the courts will recognize that all property of a debtor shall be subject to reach in proper time and manner by his creditors, save only such property as may be legally exempt, the courts will generally not extend this policy to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary. Such income does not constitute "property" within the normal meaning of state statutes defining property which is available for execution. First Northwestern Trust Co. v. IRS, *infra* at 392.

3. **Disadvantages of Domestic Trust**. Despite their relatively good track record for asset protection purposes, there are two significant problems associated with the use of domestic trusts.

a. **Rule Against Self-Settled Trust**. The reason why so many domestic trusts are established for the benefit of a grantor's family is directly attributable to statutes found in most states prohibiting a settlor from establishing a valid spendthrift trust for his own benefit. The Texas self-settled trust rule is found in §112.035 of the Texas Property Code. It provides that *"if the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate."* While the foregoing language prohibits a settlor of a trust from protecting his interest in the trust against his creditors, some consolation can be taken by the settlor in the fact that language such as the foregoing has been regularly interpreted to mean that a creditor can only reach the settlor's interest in the trust. Thus, if the settlor is entitled to receive a distribution of income from the trust, a creditor will be successful in reaching such income distributions. However, if properly structured, a self-settled trust may be able to protect its remaining corpus, theoretically for the benefit of future contingent beneficiaries of the domestic trust.

b. **Domestic Trusts Are Subject to U.S. Jurisdiction**. The fact that a domestic trust is located within the United States makes it a natural and easy target for creditor lawsuits. There are a variety of reasons why a settlor might want to avoid locating a trust within the United States.

   (i) **Personal jurisdiction**. If a domestic trust is already here, it is impossible for it to avoid becoming a target of litigation. Unlike a foreign situs trust with no presence in the United States, it is impossible for a domestic trust to claim that a court in the United States does not have jurisdiction over its assets or the trustees. Thus, even if a lawsuit is frivolous, the trustees of the domestic trust have no choice but to incur the expenditures necessary to defend the trust.

   (ii) **Confidentiality**. Secrecy should never be a necessary part of a successful asset protection plan. Nevertheless, the high financial profile of most clients involved in asset protection planning makes confidentiality an important goal of many potential settlors. If a domestic trust is sued, literally all of its records and communications, except items privileged by law, are subject to discovery.

c. **Trust Assets Are Subject To Court Control**. A domestic trust, its trustees and its assets, are subject to the whims of state and federal judges. In some cases, U.S. courts have been known to instruct trustees to take actions which are clearly in contravention of the well documented wishes of the settlor.

III. THE ALASKA "ONSHORE" TRUST

On April 1, 1997, Alaska adopted into law the Alaska Trust Act, House Bill 101. Upon its enactment, the Alaska State Legislature issued a press release entitled "Measure to Strengthen Family Trust Becomes Law." The State of Delaware has adopted similar legislation. Both pieces of legislation are ostensibly designed to provide "onshore" alternatives to offshore trusts.

A. The Alaska Trust Act. The Alaska Trust Act changed long-standing Alaskan law by making the following modifications to existing law:

1. **Self-Settled Trust Approved.** The Alaska Trust Act specifically allows the establishment of a "self-settled trust" wherein the settlor can also be a beneficiary of the trust, can receive benefits from the trust and yet protect those benefits from the claims of future creditors. By eliminating the rule against self-settled trust, Alaska has ***theoretically*** eliminated one of the major obstacles to using a domestic trust for asset protection purposes.

2. **Rule Against Perpetuities Abolished.** Admittedly, the Rule against Perpetuities is probably an anachronism that has outlived its usefulness. Most of the offshore jurisdictions have eliminated the Rule against Perpetuities as have some states. Thus, with an elimination of the Rule against Perpetuities, an Alaska trust can theoretically continue forever.

3. **Secrecy and Confidentiality Protection.** Practitioners in Alaska interpret the Alaska Trust Act to ignore that the affairs of an Alaskan trust are not subject to disclosure to third parties. Thus, in litigation against a trust within Alaska, confidential information from the trust will theoretically not be available to third parties.

B. Disadvantages and Potential Pitfalls. Notwithstanding the purported merits of the Alaska "onshore" trust, several obvious problems and many potential problems still exist. First and foremost is the fact that trusts and assets located within Alaska are still within the jurisdiction of U.S. federal courts. Federal courts have nationwide jurisdiction which is superior to that of any state court. While federal judges are bound by state law on most matters, that certainly does not apply in the case where federal law has preempted state law including (1) matters of federal income taxation and (2) the power and extent of the bankruptcy court and trustees. Clearly assets transferred into an Alaska trust by a settlor where the settlor has retained a significant interest in the trust would be reachable by both the Internal Revenue Service and a bankruptcy court trustee. In light of the fact that the Alaska Trust Act requires that an Alaska trust maintain a substantial portion of its assets in Alaska and use a trustee licensed by and a resident in Alaska, the bill appears to some commentators to be nothing more than an attempt to attract business to Alaska's banks and trust companies.

IV. USE OF FAMILY LIMITED PARTNERSHIPS

The family limited partnership has followed closely behind the domestic trust as a favorite of estate planning and asset protection planning practitioners. Although there are a multitude of benefits associated with use of a family limited partnership, the principal benefits can be categorized into several principal groups as follows:

A. Valuation Discount. While outside the scope of this paper, a traditional motivating factor in the use of family limited partnerships is the ability to claim significant discounts in the value of the partnership interest owned by a decedent at the time of his death. Notwithstanding the anti-family limited partnership provisions of IRS Code Section 2704, the Internal Revenue Service has conceded the ability of taxpayers to claim a valuation discount for lack of marketability of a minority interest notwithstanding that a controlling interest in the family limited partnership is owned by the same family.

B. Income Shifting Benefits. The idea of attempting to allocate income to individual family members in lower tax brackets is not new. The concept first gained popularity at a time when the marginal tax rates in this country were as high as 90 percent. In the leading case of Lucas v. Earl, 281 US 111 (1930), the United States Supreme Court struck down most income shifting structures by holding that the income must be taxed to the individual whose efforts generated the income. Nevertheless, the concept of a family limited partnership was eventually recognized by the Internal Revenue Code in Section 704(e) and Regulation Section 1.704-1(e). IRS Code Section 704(e)(1) provides that a person shall be recognized as a partner for purposes of Subchapter K if he or she owns a capital interest in a partnership in which capital is a material income producing factor, whether or not such interest was derived by purchase or gift from any other person. For purposes of Section 704(e)(1), the determination as to whether capital is a material income producing factor must be made by reference to all of the facts of each case. Capital is a material income producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. Reg. Section 1.704-1(e)(1)(4i).

C. Asset Protection Benefit. A third and equally compelling advantage of a family limited partnership has been the limitations placed by most state laws on the rights of creditors to reach a debtor's limited partnership interest.

1. **Charging Order Limitation**. In most states, such as Texas, a judgment creditor seeking to reach the interest of an owner of a limited partnership interest is limited to use of a "charging order" against the debtor's interest. The Texas charging order statute can be found in Tex.Rev.Civ.Stat.art. 6132a-1, §7.03. The Texas charging order rule provides that:

   "a. On application to a court of competent jurisdiction by a judgment creditor of a partner or of any other owner of a partnership interest, the court may charge the partnership interest of the partner or other owner with payment of the unsatisfied amount of the judgment, with interest, may then or later appoint a receiver of the debtor partner's share of the partnership's profits and of any other money payable or that becomes payable to the debtor partner with respect to the partnership, and may make all other orders, directions, and inquiries that the circumstances of the case require. To the extent that the partnership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the partnership interest.

b. The partnership interest charged may be redeemed at any time before foreclosure or, in case of a sale directed by the court, may be purchased without a dissolution being caused;

(1) with separate property of any general partner, by any one or more of the general partners; or

(2) with respect to partnership property, by any one or more of the general partners whose interests are not charged, on the consent of all general partners whose interests are not charged and a majority in interest of the limited partners, excluding limited partnership interests held by any general partner whose interest is charged.

c. The remedies provided by Subsection (a) of this section are exclusive of others that may exist, including remedies under laws of this state applicable to partnerships without limited partners.

d. This section does not deprive any partner of the benefit of any exemption laws applicable to that partner's partnership interest."

The fact that a judgment creditor is limited to a charging order has significant benefits. Although the debtor's interest in the limited partnership has effectively been "seized," the creditor is only entitled to receive any distributions which the debtor might have been entitled to. If the Family Limited Partnership makes no distributions to the debtor, the creditor gets nothing. Since the debtor is usually also the general partner, the general partner can decide to retain assets inside the limited partnership. And, since the judgment creditor does not gain any rights or voting power within the limited partnership, his ability to force distributions is very limited.

2. **Limited Liability Company Protection**. A similar charging order limitation can be found in Tex. Rev. Civ. Stat. art. 1528n, Art. 4.06 which provides that a judgment creditor of a member in a limited liability company can apply to a court of competent jurisdiction for an order charging the membership interest of the member with payment of the unsatisfied amount of the creditor's judgment. However, except as otherwise provided in the regulations of the limited liability company, the judgment creditor has only the rights of an assignee of the membership interest. Thus, the interest of a member charged in this fashion will result in the creditor finding itself in the uncomfortable position of not being able to foreclose on the member's interest or participate in the activities of the limited liability company, but still be required to report the member's pro rata share of income on the creditor's tax return.

3. **Revenue Ruling 77-137**. An equally effective obstacle to a creditor is Revenue Ruling 77-137 which provides that a creditor who uses a charging order to attach a limited partners income will be treated as a partner in the limited partnership for tax purposes. If the partnership earns income which is then not distributed to the partners, the creditor holding the charging order will recognize phantom income for tax purposes!

D. **Offshore Limited Partnerships.** Many offshore jurisdictions have adopted modern limited partnership legislation which is specifically designed to address the legal and tax needs of United States citizens. Some of the modern offshore limited partnership statutes have been drafted with input from U.S. attorneys active in offshore business and estate planning. Virtually any kind of provision typically drafted into a complex domestic limited partnership agreement can also be drafted into the agreement of an offshore limited partnership with virtually the same legal results being accomplished. From a federal income and estate tax standpoint, assuming all IRS reporting requirements for a foreign limited partnership are met, the tax results are similar, specifically:

- The offshore limited partnership will file a U.S. partnership return, Form 1065, on which it will report its U.S. source income.

- The limited partnership interest will be eligible for valuation discounts for gift and estate tax purposes.

On the other hand, significant differences in the ownership structure will exist when the offshore limited partnership is formed for asset protection purposes. For example, the general partner will most likely be a foreign limited liability company or International Business Corporation formed in a jurisdiction <u>different</u> from the jurisdiction in which the limited partnership is formed. Additionally, the offshore limited partnership can be formed in a jurisdiction which limits the creditor's remedies to a "charging order" against the limited partnership interest. If the general partner is a foreign limited liability company formed in Nevis, the general partner will enjoy the same charging order protection under the Nevis Limited Liability Company Ordinance of 1995 as the limited partnership. If an offshore trust owns the limited partnership interest, it is possible that a creditor may be forced to consider filing a lawsuit in three different jurisdictions, assuming the creditor has reason to believe it can reach trust assets in the first place.

V. FOREIGN SITUS TRUSTS

The inherent problems associated with domestic trusts, aggravated by outrageous jury judgments and, in some cases, overreaching judges, have prompted many individuals to seek asset preservation mechanisms beyond the borders of the United States. Although transfers of assets offshore has traditionally been associated with illegal attempts to evade tax or conceal assets, foreign situs trusts have become generally acceptable throughout the world as a legitimate means to deal with the uncertainties of an unpredictable judiciary.

There are numerous benefits available to using a foreign situs trust as part of a legitimate asset preservation plan for a client. This is an area of the law that is constantly changing as a result of (i) modernized and more aggressive asset protection trust legislation passed by various offshore jurisdictions and (ii) changing U.S. laws and court decisions apparently in response to the ever increasing use of offshore trusts by U.S. citizens. Nevertheless, a brief summary of the advantages of using a foreign situs trust is as follows.

A. Benefits of Foreign Situs Trust

1. **Self-Settled Trust Permissible**. Most offshore jurisdictions will permit a settlor to establish a self-settled trust wherein the settlor retains beneficial enjoyment or control over the trust assets and/or the administration of the trust, something which is typically not possible in the U.S. Although it is typically a better planning strategy to avoid any unnecessary control on the part of a settlor, the fact that the settlor has retained a beneficial interest in the trust or has a right to exercise certain defined powers in the trust has, in many jurisdictions, been expressly permitted by statute.

2. **Chilling Effect of Offshore Trust**. Although primarily psychological in nature, a potential creditor and his/her attorney will not welcome the news that a debtor's assets have been sheltered in an offshore trust. An offshore trust constitutes an additional hurdle which the creditor will have to overcome. The mere logistical obstacles presented by the distance of some of these offshore jurisdictions is enough to drive plaintiffs to the settlement table.

3. **Non-recognition of Foreign Judgments**. Even if a Plaintiff were to obtain a judgment against a Defendant, most offshore jurisdictions will not recognize a foreign judgment. Under the law of most offshore jurisdictions, a creditor must file suit in the jurisdiction in which the trust is located if a creditor intends to enforce a judgment against assets of the trust. Plaintiffs and their attorneys are

sometimes surprised to learn that contingency fee arrangements are unique to the United States and, in some offshore jurisdictions, outright illegal.

4. **Confidentiality**. A legitimate asset protection plan contemplates that a debtor will be prepared to make full and complete disclosure, if compelled to do so, regarding the transfers that were made into an offshore trust. Secrecy should never be a necessary element of a legitimate asset protection plan. Nevertheless, the traditional cloak of secrecy which is found in most offshore jurisdictions is a benefit which is valued by many U.S. clients who wish to keep a low profile for a variety of reasons. Typically, unless the debtor has committed a crime which is also a crime in the jurisdiction in which the trust is located, an offshore jurisdiction will not provide confidential information about the debtor's affairs without the debtor's consent. Since most offshore financial centers are tax havens with no income or estate taxes, no "tax crimes" are legally possible. Thus, almost all offshore jurisdictions will decline to cooperate with criminal tax investigations of the United States or United Kingdom.

5. **Unambiguous Fraudulent Conveyance Laws and Statute of Limitations**. Few offshore jurisdictions condone a fraudulent conveyance. However, most offshore jurisdictions have attempted to clarify the issue of fraudulent conveyance by drafting clearly defined fraudulent conveyance legislation. This modern legislation has attempted to eliminate many of the ambiguities and unpredictable results which have caused uncertainty for both debtors and creditors alike, both in the United States and in the United Kingdom. Likewise, most jurisdictions have acted to shorten the statute of limitation periods applicable to fraudulent conveyances. (Contrary to popular belief, the Cayman Islands, commonly thought as a debtor haven, has a six year statute of limitations!)

6. **Avoidance of Pre-Marital Agreements, Marital Property Laws and Forced Heirship**. Regrettably, the sacrament of marriage is not as sacred as it once was. It is not uncommon to have a U.S. client that is working on his third marriage. If the client has begun to accumulate wealth, notwithstanding prior divorces, future marriages can continue to be problematic when the issue of prenuptial agreements is first discussed. The need for a pre-marital agreement can be avoided altogether through the establishment of an offshore trust prior to marriage. It not only avoids the unpleasant task of asking a future spouse to sign a pre-marital agreement, it also prevents the need to make the vast financial disclosure that is required under most state laws to make such agreements enforceable. In fact, the future spouse does not even need to know about the existence of the offshore trust. Upon divorce, the assets in the trust are safely and legally outside the jurisdiction of a divorce court.

Likewise, a settlor may be surprised to learn that in most states he will not be able to freely dispose of his property through his Will at the time of his death. Forced heirship laws throughout the United States grant spouses and children of the decedent certain heirship rights in the decedent's estate. These types of problems can be properly addressed through the use of an offshore trust established in a jurisdiction that has adopted legislation to prevent the application of forced heirship laws and forced marital property laws in the debtor's home jurisdiction.

B. **Selecting a Favorable Jurisdiction**. Great care must be used in selecting the situs of an offshore trust. The availability of the characteristics which must be included in a foreign situs trust should be specifically identified in the governing legislation of any jurisdiction being considered for the situs of an offshore trust. Among the factors that should be used in evaluating a particular jurisdiction are:

1. non-recognition of foreign judgments;

2. recognition and protection of self-settled trusts;

3. recognition and protection of trusts wherein the grantor has retained significant control over trust assets or administration;

4. confidentiality;

5. unambiguous fraudulent conveyance laws and favorable statute of limitation periods;

6. recognition of trust provisions which override the forced heirship laws or marital property laws of the debtor's home jurisdiction;

7. favorable tax law (almost all offshore jurisdictions exempt foreign trust from taxation in their jurisdiction);

8. the availability of competent and financially strong trustees;

9. the availability of local professional services, including legal counsel;

10. the proximity of the jurisdiction to the United States;

11. the availability of modern telecommunications, including reliable telephone and communication facilities;

12. the compatibility of the offshore jurisdiction to the settlor's language and culture (not all offshore "tax havens" are English speaking); and

13. the existence of a modern and stable government.

VI. STRUCTURING AN OFFSHORE ASSET PROTECTION TRUST

Many of the considerations applicable to the formation of a domestic trust are also applicable to the formation of a foreign trust. Certain considerations, such as the choice of a trustee, are amplified when using a foreign trustee. Rarely is a U.S. client comfortable with the prospect of having his/her assets and wealth subject to the control of an individual or trust company in a foreign jurisdiction. However, in times of crisis, the competency of the trustee will have a significant effect on whether an offshore trust can successfully withstand a creditor attack from the U.S.

A. Significant Offshore Trust Provisions. As with any legal document, a trust agreement for a foreign situs trust should be drafted to reflect the wishes of the settlor. Although such a trust instrument will include provisions which are typically not found in a domestic trust agreement, a practitioner advising a U.S. client on establishing a foreign trust should first identify the settlor's overall wishes and goals. These desires will then be incorporated into the offshore trust agreement just in the same way as they are in a domestic trust agreement. Of course, any such provisions will have to comply with the law of the offshore jurisdiction which has been selected for the trust. In addition to the foregoing, the trust should include the following provisions:

1. Self Settled Trust. Assuming it is permissible under the jurisdiction chosen for the situs of the trust, the trust agreement will usually provide that the settlor has and can retain a beneficial interest in the income or corpus of the trust. Great care should be used in selecting a jurisdiction for such a trust as not all offshore jurisdictions will recognize self-settled trusts.

2. Family Limited Partnership. One of the techniques commonly used to enable a settlor to legally retain control over the assets transferred into a trust is to first transfer those assets into a family limited partnership. The settlor will be named as a general partner of the partnership and retain a 1 percent interest in the partnership. He will also usually be named as the sole limited partner, holding a 99 percent partnership interest. The limited partnership interest is then transferred to the offshore trust. The settlor then continues to effectively exercise control over the assets transferred into the trust without having any actual control or right to control the trust itself.

A properly structured offshore trust agreement should nevertheless provide that the trustee may liquidate the family limited partnership and transfer the assets and control of the assets to the trust in the event that an unfavorable creditor situation arises in the settlor's home jurisdiction.

3. **Ability to Change Situs of Trust**. It is not unusual for a U.S. client to respond unfavorably to the idea of establishing a trust in a jurisdiction which he had never heard of prior to consulting with you. If a settlor genuinely is creditor free or solvent, the U.S. client may prefer to establish his trust in a better known jurisdiction such as the Cayman Islands which may not have ideal legislation. In those cases, this problem can be resolved by a provision in the trust agreement which authorizes the trustees to change the situs of the trust upon the happening of certain unfavorable events. Thus, for example, if a trust is established in Bermuda, a "flee clause" will authorize the trustees in Bermuda to change the situs of the trust to a more favorable offshore jurisdiction if it appears to the trustees in Bermuda that the trust will come under attack in Bermuda as a result of unforeseen problems in the debtor's home country.

4. **Ability to Change Trustees**. The trust agreement should also provide that, upon the happening of certain events, the trustees of the offshore trust may be changed. This can become necessary in a variety of circumstances, not the least of which is a situation where the existing trustee may be found to come under the jurisdiction of a U.S. court. Should that occur, the trust agreement can provide for the automatic removal of the "tainted" trustee and the appointment of a new trustee or trustees.

5. **Ability to Move Trust Assets**. The trustees of an offshore trust should typically be given broad authority to move assets of the trust for specific enumerated reasons. So long as the trustees have a legitimate reason to continue to protect the assets of the trust, the trustees will owe a fiduciary duty to the trust and its beneficiaries to protect its assets by moving them, if necessary, to a more favorable jurisdiction.

6. **Anti-Duress Clause**. The mere fact that the law of an offshore jurisdiction allows a settlor to retain beneficial enjoyment or control of trust assets does not prevent a U.S. settlor from coming under the very effective influence of a U.S. judge. If the U.S. settlor resides in the United States, he is subject to the jurisdiction of its courts. If the settlor has retained the ability to control the beneficial enjoyment or administration of an offshore trust, he can be ordered by an American court to exercise those rights and control in a manner which is inconsistent with his goals in establishing the trust to begin with. For example, if a U.S. settlor has retained the right to demand distributions of income or corpus from a foreign trust, a U.S. court can order a settlor under its jurisdiction to exercise those controls in such a way as to repatriate the income or corpus for the benefit of the debtor's creditors. Failure to abide by the court's order will always result in incarceration until the order is complied with. An anti-duress clause in a properly structured trust agreement will permit the trustee of an

offshore trust to ignore the settlor's demands if the trustee has reason to believe that the settlor has made the request under duress.

7. **Use of a Protector**. An alternative to an anti-duress clause is the use of a protector. The concept of a protector is typically unknown within the United States, but is common in offshore jurisdictions. The legislation of most offshore jurisdictions recognize the concept of the protector. A protector is the "guardian angel" of a trust. It is typically an individual who has been granted significant and well defined veto powers over certain proposed actions of the trustee. For example, if a trustee in an offshore jurisdiction should receive instructions from the grantor to repatriate assets of the trust in clear contravention of the settlor's original wishes, the protector has the right to veto such request if the protector, in his sole and absolute judgment, believes that the repatriation of assets would be inconsistent with the settlor's original intent. Powers usually granted a trust protector include the power to:

   (i) remove a trustee;

   (ii) cause the trust to relocate to another jurisdiction;

   (iii) freeze benefits payable to beneficiaries who have encountered creditor, marital or other problems;

   (iv) add beneficiaries, within parameters outlined by the settlor in his or her "Letter of Wishes"; and

   (v) authorize the amendment of the trust amendment to update the document for income or estate tax purposes.

B. Use of Partnerships with Offshore Trusts. Most offshore trusts utilize the benefits associated with a partnership to hold assets which a settlor transfers to an offshore trust. There are two reasons for this. First, a settlor who is in a position to transfer significant liquidity or assets to an offshore trust is probably qualified to manage those assets himself, particularly if the assets consist of an ongoing business. By transferring the assets to an entity owned by the offshore trust but managed by the settlor as general partner, the settlor is able to continue to manage the assets while achieving a significant degree of asset protection.

A second and compelling reason for having assets transferred into a partnership to be managed by the settlor is the reduced managerial costs involved in the management of the protected assets. A trust that owns an interest in a limited partnership is not required to undertake the day to day management of assets as it would if the trust were the direct owner of those assets. As a result, the offshore trustee can justify a substantially reduced trustee fee which might otherwise be as high as 1% the value of the managed assets with a minimum $2,500 management fee.

If it is desirous to have an offshore trust use a "drop-down" entity such as a family limited partnership ("FLP"), several steps are involved:

1. **Formation of FLP**. The settlor begins the formation process by identifying the assets to be transferred into the FLP. Any asset will qualify for such purpose although assets typically transferred are marketable securities, antiques, collectibles, and any business interest owned by the settlor. Assets exempt from creditor claims under state law are typically not transferred. Immediately after the transfer, the settlor holds a 1% interest in the entity in his capacity as general partner and a 99% interest as a limited partner.

2. **Formation of Offshore Trust**. Simultaneous with the formation of the family limited partnership, the settlor forms an offshore asset protection trust. In a typical situation, the settlor and/or members of his family are the sole beneficiaries of the trust.

3. **Transfer of 99% of FLP to Trust**. Upon formation of the trust, the settlor transfers his 99% interest in the limited partnership to the asset protection trust. Thereafter, the asset protection trust is the owner, through the family limited partnership, of 99% of the assets protected by the trust. However, the assets remain inside the "drop down" entity which continues to be managed by the settlor in his capacity as general partner.

VII. OVERVIEW OF APPLICABLE FOREIGN LAW

Possibly the most important decision to be made in establishing an offshore trust is the selection of a home jurisdiction for the trust. All offshore jurisdictions which are active in seeking asset protection trusts have also been active in modernizing the law governing such trusts. However, there still exists a broad range of options and differences amongst the various jurisdictions.

Traditional offshore havens, such as the Bahamas and the Cayman Islands, continue to offer a multitude of advantages. However, they are not necessarily the most advantageous jurisdictions, from a trust legislation standpoint. On the other hand, many jurisdictions which have favorable legislation are small and have new but untested legislation. The following is the status of legislation in several popular offshore jurisdictions.

A. BAHAMAS.

1. **Location and History.** The Bahamas is a group of 700 islands stretching in a 600 mile arc which begins approximately 40 miles east of Palm Beach, Florida, and extends to just north of Haiti. The capital of the Bahamas is Nassau which is located on New Providence Islands, where approximately one-half of the people of the Bahamas live. Although discovered by Christopher Columbus in

1492, the United Kingdom claimed and controlled the Bahamas as a colony until 1964 when the Bahamas was granted internal self-determination.

2. **Government.** The Bahamas are an independent member of the British Commonwealth of Nations. The Bahamas have a legislative form of government, headed by an elected prime minister. The legislature consists of a 49 member House Assembly and a 16 member Senate. As with most commonwealth members, the Bahamian judicial system is based upon the English law, as modified by Bahamian statutory law. The highest court in the land is the Supreme Court although appeals from the Supreme Court can be heard by the judicial committee of the Privi Council of the United Kingdom.

3. **Trust Law.** The trust law of the Bahamas is found in the non statutory common law of England as it exists in the Bahamas as well as the Trust Act of 1989 and the Fraudulent Dispositions Act of 1991. The bulk of Bahamian trust law is based upon traditional notions of trust law found in the United Kingdom. The Trust Act of 1989, which was extensively amended and modernized in 1996, does provide that Bahamian law will govern a trust to defeat forced heirship rules. A Bahamian trust is a private agreement between the settlor and the trustee. There is no filing requirement with the Bahamian government nor are there any government fees associated with the formation of a Bahamas trust. The trust law revisions adopted in 1996 were designed, in part, to clarify and modernized portions of the law that had been weakened by various court cases in the Bahamas. The revisions have been describe by some commentators as attempt to adopt statutory recognition of the existence and validity of asset protection trusts as other jurisdictions have done in recent years.

4. **Fraudulent Transfers.** The Fraudulent Dispositions Act 1991 repealed the Statute of Elizabeth and in its place adopted a strict two year statute of limitations on actions or proceedings to set aside a fraudulent conveyance. The Act defines a fraudulent disposition as one made with "an intent to defraud and at an undervalue" and shall be voidable at the instance of the creditor thereby prejudiced. In addition to proving that the obligation existed on or prior to the date of the relevant disposition, the creditor must also prove that the transferor had notice of the alleged obligation.

5. **Company Law.** The Bahamas has very modern legislation providing for the formation and use of international business companies, commonly called IBC's. Since enactment of the International Business Companies Act, approximately 40,000 IBC's have been formed pursuant to the Act. IBC's are regular corporations which may conduct business anywhere in the world but whose activities within the Bahamas are limited. The Bahamas was one of the few English speaking jurisdictions which will accept formation documents in Spanish,

so long as an English translation is provided. Once formed, a Bahamian IBC will be managed by its Board of Directors pursuant to its Articles of Association and Memorandum of Association, the Bahamian equivalent to Articles of Incorporation and Bylaws.

B. BERMUDA.

1. **Location and History.** Bermuda is a very isolated set of islands located approximately 580 miles east of Cape Hatteras, North Carolina. It consists of seven principal islands and contains approximately 20.5 square miles with a population of approximately 59,000. The capital of Bermuda is Hamilton.

2. **Government.** Bermuda is an independent member of the British Commonwealth, originally having been colonized in 1612. The Constitution provides for the existence of a legislative assembly made up of 40 elected members in the House of Assembly and 11 appointed members of the Senate. The legal system is based upon the English common law and all English statutes in force on July 11, 1612, except as otherwise modified or amended by Bermuda law.

3. **Trust Law.** The trust law of Bermuda is based upon the common law of the island and the United Kingdom. The island has adopted several pieces of legislation which govern trustees and trust companies operating trusts in Bermuda. However, there is no specific asset protection trust legislation in Bermuda. The Trustee Act of 1975 does outline the powers and duties of a trustee in Bermuda while the Trust (Special Provisions) Act 1989 allows a Bermuda trust to incorporate the wide investment and administrative provisions offered thereby. However, issues involving settlors, beneficiaries and their powers and rights are left to common law.

4. **Fraudulent Transfers.** Section 11 of the 1989 Trustee Act provides that a trust which is validly created under Bermuda law cannot be set aside or modified by a court in Bermuda pursuant to the foreign laws of another jurisdiction which govern (a) marital rights, (b) heirship rights or (c) govern the protection of creditors in matters of insolvency, unless the law in Bermuda has corresponding law or public policy rules. A Bermuda court will recognize and enforce a U.S. judgment rendered against a settlor of a Bermuda trust where (a) a Bermuda court has jurisdiction over the settlor, (b) the relevant U.S. court which rendered the judgment had jurisdiction over the judgment debtor in accordance with the conflict rules of Bermuda, (c) such judgment is final and conclusive in the foreign court and involving taxes, fines or penalties, (d) the judgment was not obtained by fraud, (e) the enforcement of the judgment does not contravene the public policy of Bermuda, and (f) the rules of natural justice

were observed in the foreign proceedings. However, a judgment creditor in Bermuda can argue that a trust is a sham arrangement or that it was established in violation of Section 45 of the Bermuda Bankruptcy Act of 1989 which provides that any transfers into a Bermuda trust shall be void against the trustee in bankruptcy if the debtor becomes insolvent two years after the date of the trust settlement.

5. **Company Law.** While Bermuda does provide provisions for exempted companies under local law, incorporation of a company in Bermuda is still a lengthy process, sometimes taking as long as four weeks. Under Bermuda law, companies doing business in Bermuda must be owned 60 percent by Bermudans. Conversely, a Bermuda "exempt" company is one which is exempted from this ownership percentage but must generally conduct business outside of Bermuda. A partnership in Bermuda may be established either as a general partnership or a limited partnership. There are currently no provisions under Bermuda law for a limited liability company. Most partnerships formed in conjunction with an offshore trust are formed as exempted limited partnerships. A Bermuda limited partnership acts much the same way as a U.S. partnership. There must be at least one general partner and one limited partner. The general partner or partners are jointly and severally liable for all of the debts of the partnership. A limited partnership is formed with the filing of a certificate of limited partnership with the Registrar of Companies. Formation of the limited partnership must be published in a local newspaper and must specify the name of the partnership, and the name and address of the general partners of the partnership. An exempted partnership under Bermuda law generally may not conduct business in Bermuda.

C. **CAYMAN ISLANDS**. The Cayman Islands are the fourth largest financial center in the world. Despite being a small island with a mere 31,000 residents, the Cayman Islands are home to 545 banks and trust companies, including 50 of the world's largest banks. One of the advantages traditionally sought in the Caymans is its reputation for secrecy. The *Confidential Relations (Preservation) Law* makes it a criminal offense for any person to reveal confidential information or attempt to obtain confidential information about private companies or trusts or the financial affairs of an individual.

1. **Location and History.** The Cayman Islands are a remote group of islands located in the northwestern Caribbean approximately 475 miles southwest of Miami, 125 miles south of Cuba and 125 miles west of Jamaica. Although three islands make up the Cayman Islands, the financial center of the Cayman Islands is the City of Georgetown located on Grand Cayman. The 31,000 residents of the Cayman Islands enjoy the highest standard of living of any island in the Caribbean with the median income exceeding $50,000 per year. The Cayman Islands were administered as a British colony until 1962. At that time, the Cayman Islands were administered together with the island of Jamaica. When the people of Jamaica elected to declare their independence, the Cayman Islands elected to remain a British colony.

2. **Government.** The Cayman Islands are a **dependent** British territory. The constitution of the Cayman Islands was enacted pursuant to the British West Indies Act of 1962, a statute of the United Kingdom. Cayman law is based upon the English common law, as modified by Cayman statutory law. The Cayman Islands are governed by a popularly elected 12 member legislative assembly although its governor is appointed by the British government. Courts in the Cayman Islands act very much like British courts and appeals from decisions of Cayman courts are appealable to the Privi Council in the United Kingdom.

3. **Trust Law.** The trust law of the Cayman Islands is based upon a combination of English common law and statutory law. Statutory laws which most principally affect Cayman trusts are the Trust Law of 1996, the Perpetuities Law, 1995 (as amended 1997) and the Fraudulent Dispositions Law of 1989. Under Cayman law, the settlor of a trust may also be a beneficiary and, in certain circumstances, can act as a co-trustee. However, the settlor cannot be both the sole trustee and the sole beneficiary of a trust. A provision in the trust agreement providing that the trust shall be governed under the laws of the Cayman Islands is enforceable regardless of any other fact circumstances. It is not necessary that the trustees or the beneficiaries of the trust be residents of the Cayman Islands or that the trust property be located there. For trusts created after 1995, the Perpetuities Law, 1995, abolished the Rule against Perpetuities.

   One area where the Cayman Islands has been aggressive is in its application of Cayman law to local trusts. Virtually all questions concerning a trust itself, including the settlor's capacity to settle the trust, are to be decided under Cayman Island law. However, there are several exceptions to this general rule. First, foreign laws may be applied to determine a settlor's ownership of property transferred into a Cayman trust before 1987. Secondly, the validity of a testamentary Cayman Islands trust is governed by the law of the testator's domicile at the time of his or her death. A Cayman Island trust may also provide that certain parts of the trust will be governed under foreign law.

4. **Fraudulent Transfers.** The Fraudulent Dispositions Law, 1989 replaced the Statute of Elizabeth and shifted the burden of proof to a creditor wishing to set aside a transfer to a trust. While the Act includes the usual provisions which favor a debtor being able to protect transfers into a trust, a creditor is allowed **six years** in which to challenge an alleged fraudulent transfer into a Cayman trust.

5. **Company Law.** The Cayman Islands has excellent and mature corporate law which is one of the primary reasons it is the home to 40,000 companies. Cayman corporations generally fall into four categories.

   a. **Ordinary Resident Company.** An ordinary (resident) company is a Cayman corporation which is incorporated to conduct business in the Cayman Islands. It is the only company which is authorized to own real estate in the Cayman Islands without government approval.

   b. **Ordinary Non-resident Company.** An ordinary (non resident) company is a Cayman corporation which is not authorized to conduct business within the islands. Most Cayman registered ships are incorporated by an ordinary (non resident) company.

   c. **Exempt Company.** An exempt company is an international business corporation which is prohibited from directly or indirectly conducting business on the Cayman Islands, provided however, that an exempt company may own real estate in the Cayman Islands if approved by the Financial Secretary. Unlike an ordinary non resident company, an exempt company is exempt from Cayman taxation for 20 years. Moreover, an exempt company may be formed as a limited duration company (LDC), which is specifically designed to qualify for partnership treatment under the U.S. tax code.

   d. **Partnership.** Cayman law also provides for the formation of general and limited partnerships. The Exempted Limited Partnership Law 1991 allows for the formation of a limited partnership similar to a U.S. limited partnership. At least one general partner of an exempted limited partnership must be domiciled in the Cayman Islands, although a locally formed corporation may serve that purpose.

D. COOK ISLANDS.

1. **Location and History.** The Cook Islands are located in the Pacific islands, approximately 4,000 kilometers due south of Hawaii and 3,200 miles northeast of New Zealand. Prior to 1965, the Cook Islands were governed by New Zealand. The capital of the Cooks Islands is Rarotonga.

2. **Government.** The Cook Islands obtained its independence from New Zealand in 1965. The constitution provides for a parliament with one single governing body.

3. **Trust Law.** The International Trusts Acts of 1984, as amended, is one of the best known attempts to provide statutory clarity in the area of asset protection trusts. Strict statute of limitations exist governing the ability to challenge an asset protection trust. A settlor can be a beneficiary of his own trust or retain some control over trust affairs. Not only are foreign judgments not recognized in the Cook Islands, contingency fee agreements are specifically prohibited by law.

An example of the specificity of Cook Island law is provided by the statute of limitations applicable to challenging a transfer to a trust. Section 13B of the Act provides that a transfer to a trust shall not be deemed fraudulent if it occurs after the expiration of two years from the date that the creditor's cause of action accrued or, if the trust is established before the expiration of two years from the date the creditor's cause of action accrued, if the creditor fails to commence an action before the expiration of one year from the date the alleged fraudulent disposition took place. The International Trust Amendment Act of 1995-96 did add an exception to the foregoing rule in those situations where a creditor had already commenced proceedings on its cause of action against a settlor in a "court of competent jurisdiction."

Section 13B of the Trust Act further provides that an international trust settled or established and a disposition of property to such trust shall for all purposes be deemed not to have been so settled or established, or the property disposed of with intent to defraud a creditor if the settlement, establishment or disposition of property took place before that creditor's cause of action accrued.

A settlor shall not have imputed to him an intent to defraud a creditor solely by reason that the settlor:

(a) Has settled or established a trust or has disposed of property to such trust within two years from the date of that creditor's cause of action accruing;

(b) Has retained, possesses or acquires any of the powers or benefits referred to in paragraphs (a) to (f) of section 13C (broad powers retained by settlor);

(c) Is a beneficiary, trustee, or protector;

(d) Has settled or established a trust, or has disposed of property to such trust at a time when proceedings in respect of that creditor's cause of action against the settlor have already been commenced in a court of competent jurisdiction.

The government of the Cook Islands enacted the Trustee Company's (Due Diligence) Regulations in 1996 which was adopted to prevent the use of the Cook Islands by individuals establishing trusts in the Cooks with the intention of defrauding existing and contingent creditors. The new regulations require that, prior to the registration of the trust, a solvency affidavit must be submitted by a settlor, and such solvency affidavit must reflect that the settlor is solvent and is financially able to satisfy all of his known and contingent creditors out of nontransferred assets. The form of the affidavit is prescribed by regulation.

4. **Fraudulent Transfers.** As discussed above, Section 13B of the Act provides that a transfer to a trust shall not be deemed fraudulent if it occurs after the expiration of two years from the date that the creditor's cause of action accrued or, if the trust is established before the expiration of two years from the date the creditor's cause of action accrued, if the creditor fails to commence an action before the expiration of one year from the date the alleged fraudulent disposition took place.

5. **Company Law.** Incorporation of companies under the Cook Islands is provided by the Companies Act 1970-1971. However, most companies used in connection with offshore activities are incorporated under the International Companies Act 1981-1982 (as amended 1996). One unique aspect of Cook Islands company law is the flexibility allowed in the drafting of its corporate structure. For example, a Cook Island International Business Corporation can be incorporated as a no liability entity or as an unlimited liability company or as a company limited by guarantee.

E. ISLE OF MAN.

1. **Location and History.** The Isle of Man is located in the Irish Sea virtually in the center of the British isles, bordered on the north by Scotland, on the east by England and on the west by Ireland. It is approximately 33 miles long and 13 miles wide. It is one of the oldest members of the British Commonwealth.

2. **Government.** The Isle of Man is a **dependent** member of the British Commonwealth. The island itself is governed by its thousand year old parliament called the Tynwald which has two branches, a House of Keys which is composed of 24 popularly elected members and a Legislative Council which is a combination of House of Keys members and appointed officials. The Isle of Man legal system is based upon the English common law system. Although British law per se does not apply in the Isle of Man, final appeal of court cases from the Isle of Man is to the Privi Council in the United Kingdom.

3. **Trust Law.** Until very recently, the Isle of Man relied on trust law as developed by the United Kingdom and its Commonwealth members. Two recent amendments to the existing Trust Act of the Isle of Man have attempted to adopt trust legislation which is comparable to that found on the Cayman Islands and Bermuda. However, this legislation is not considered to be asset protection trust specific and is still heavily dependent upon concepts and principles found in the English common law. Moreover, the Rule of Perpetuities on the Isle of Man has not been eliminated, although its length has been shortened to 80 years. Registration of trusts on the Isle of Man is not required. There is no taxation of an offshore trust on the Isle of Man so long as the settlor and the beneficiaries are non residents and the trust income is derived from outside the Isle of Man.

4. **Fraudulent Transfers.** There is no specific legislation in the Isle of Man which governs fraudulent conveyances. There is dicta in at least one court case which implies that the Statute of Elizabeth applies on the Isle of Man. However, the law in this area is still unclear.

5. **Company Law.** Corporate law in the Isle of Man was not generally significant until it adopted the limited liability company act of 1996 which is expressly modeled on the U.S. form.

F. LIECHTENSTEIN.

1. **Location and History.** The principality of Liechtenstein is a tiny jurisdiction nestled in between Switzerland and Austria and located approximately 110 kilometers east of Zurich, Switzerland. It has a size of 160 square kilometers and is Europe's fourth smallest state. The capital of Liechtenstein is Vaduz. It has a population of approximately 28,000 of which 18,000 are citizens.

2. **Government.** The principality of Liechtenstein is a constitutional hereditary monarchy based upon a democratic and parliamentary system. The current constitution was adopted in 1921. Liechtenstein is historically a civil law jurisdiction. The official language of Liechtenstein is German and all official documents in Liechtenstein, including lawsuits, must be filed in German.

3. **Trust Law.** Although traditionally a civil law jurisdiction, Liechtenstein became one of the first European nations to adopt a statutory trust law. The current trust law is found in articles 897-923A of the *Personen und Gesellechaftsrecht* (Persons and Companies Law) of January 20, 1926. Modifications to the trust law were made in 1980.

A trust is formed and based upon a written declaration by the trustee. If the trust is created to exceed a duration of 12 months, it must be registered with the Public Register. However, a trust need not be registered if a certified copy of the trust deed is deposited with the Public Register within 12 months of its formation. A trust deed deposited in such a manner is not open to the public.

A settlor of a Liechtenstein trust may also be a beneficiary of the trust provided that if he is also a trustee, he may not also be the sole beneficiary. The trustees are designated by the trust deed and may be of any nationality or place of residence provided however that one trustee must have residence in Liechtenstein.

4. **Foundations (Stiftung).** One of the more unique features of the law in Liechtenstein is the ability to form a private foundation, known in Liechtenstein as the "*Stiftung*" (Property and Companies Law Art 552-570). A foundation in Liechtenstein is a fund or collection of property dedicated to a specific purpose. It is similar in some respects to a common law trust except that the foundation is a separate legal entity that is controlled by its board of directors and governed by the foundation deed which is the document establishing the foundation. The foundation deed, similar to a trust deed, must be filed with the public registry. However, although so filed, the foundation deed is not generally available for public inspection.

All provisions concerning the actual workings of the foundation and all confidential information, including the identity of the beneficiaries of the foundation, are set forth in the foundation's internal regulations. These regulations are adopted by the foundation's board of directors and are not filed with any public authority. The deeds and regulations of the foundation constitute its governing documents.

The minimum capital for a Liechtenstein foundation is 30,000 Swiss francs, or about $21,000 US.

Although a private foundation in Liechtenstein may be used for generally any non-commercial purpose, including traditional charitable purposes, they can be and are routinely used as private family foundations. In other words, the foundation deed and purpose, as established by the founder, can provide that the beneficiaries of the trust are the founder himself and/or his or her family. Although a private foundation may not generally engage in commercial activities, it may hold shares or other ownership interest of other companies that do. Once established, the foundation is treated as an independent legal entity, legally separate from the founder, assuming the foundation deed is properly formed and the foundation was not established for a fraudulent purpose.

As noted above, the affairs of the foundation are run by the board of directors. The foundation deed may provide broad powers to the board of directors including the power to add additional beneficiaries to the foundation.

A private foundation in Liechtenstein is subject to an annual capital tax equal to one percent of the foundation's capital, subject to a minimum payment of 1,000 Swiss francs. The taxes reduced for foundations as the capital increases and caps off at .005 percent for foundations with capital in excess of 10 million Swiss francs.

5. **Fraudulent Transfers.** Foreign judgments will not be enforced in Liechtenstein. However, local law does allow a creditor of a settlor to attack the transfer of assets to a Liechtenstein trust if the creditor can show that the transfer was made to defraud creditors. A five-year statute of limitations is generally applicable.

6. **Company Law.** As with trusts and foundations, the law governing the formation of companies in Liechtenstein is found in the *Personen und Gesellechaftsrecht* or the "PGR" (Persons and Companies Law). Analogous to a regular corporation is a "company limited by shares," or the *aktiengesellschaft*, (PGR Art. 261-367). A *aktiengesellschaft* is a stock corporation, the capital of which has been divided into bearer or registered shares. The minimum required capital is 50,000 Swiss francs or its equivalent in a foreign currency. The capital must be fully paid upon formation of the company. Capital in excess of 50,000 Swiss francs must be at least 20 percent paid upon formation, in the case of registered shares, and 50 percent paid in the case of bearer shares, assuming the articles of incorporation expressly permit less than full payment for such bearer shares. Payment may be in cash or in kind, but any non cash contribution must be substantiated by supporting documentation.

The shareholders of the *aktiengesellschaft*, provided their shares are fully paid, are not personally liable for the debts of the company. The company may pursue any commercial or non-commercial purpose and is required to keep accounts, appoint auditors, and submit audited balance sheets to the Liechtenstein Tax Administration annually. Management of the company is vested in a board of directors consisting of one or more members, elected by the shareholders.

A *aktiengesellschaft* must pay an annual capital tax equal to one percent of the paid up capital and reserves of the company, subject to a minimum tax of 1,000 Swiss francs. No taxes are payable on the earnings or profits of the company.

In addition, a tax of four percent is payable by the company on all dividends distributed to shareholders and on any distribution of surplus upon liquidation.

G. NEVIS.

1. **Location and History.** Nevis is located in the Leeward Islands in the Eastern Caribbean approximately 1200 miles southeast of Miami and 225 miles southeast of Puerto Rico. The island has a current population of 9,500. English is the official and commercial language. The island of Nevis, together with St. Kitts and Anguilla, formerly formed the West Indies Federation, a British colony until 1967. At that time, Anguilla seceded from the federation. In 1983, the Federation of St. Kitts & Nevis attained full political independence.

2. **Government.** Nevis is currently a member of the Sovereign Federation of St. Kitts and Nevis and is an independent member of the British Commonwealth. Nevis is its own political subdivision under the Federation, with its own Assembly. Under the Constitution of the Federation, Nevis may become an independent state by a two-thirds public referendum vote of the citizens of Nevis. At the current time, Nevis is actively pursuing independence from the Federation. The legal system is based upon the English common law and is part of the West Indies court system. The court of last resort, as in most Caribbean jurisdictions, is the Privi Council in the United Kingdom.

3. **Trust Law.** Nevis recently enacted the Nevis International Exempt Trust Ordinance of 1994 which is modeled after the trust legislation of the Cook Islands. The Ordinance is specifically tailored to make Nevis a preferred jurisdiction in the Caribbean for the establishment of asset protection trusts.

   Under Nevis trust law, the same person can, but is not required to be the settlor, the beneficiary and the protector of the trust. Any of the foregoing may be residents or non-residents of Nevis. Nevis law does require the appointment of a trust "protector" who oversees the trustee's operation of the trust. The protector is not involved in active management of the trust but does have veto power over certain decisions of the trust. The protector may also replace a trustee or relocate the situs of the trust if necessary.

   A creditor seeking to set aside a transfer to a Nevis trust must establish beyond reasonable doubt that the transfer constituted a fraudulent disposition. The Nevis Trust Ordinance expressly states that a trust settled or established or a disposition to the trust shall not be fraudulent as against a creditor or a settlor:

- If settlement, establishment or the disposition to the trust takes place more than two years from the date the creditor's cause of action accrued, or

- If the settlement, establishment or disposition takes place before the expiration of two years from the date that the settlor's cause of action accrued, the creditor fails to commence an action before the expiration of one year from the date of settlement, establishment or disposition.

Any action to set aside a trust settlement or a disposition to a Nevis international trust must be commenced in the High Court of Nevis. Any creditor filing an action in Nevis against a Nevis trust must file a $25,000.00 bond to secure payment of costs with the Ministry of Finance.

In addition to providing for aggressive protection against creditors, a Nevis international trust also modifies or eliminates certain common law concepts such as elimination of the Rule against Perpetuities, and overriding the heirship rights of the domicile of the settlor.

4. **Fraudulent Transfers.** Foreign judgments are not recognized in Nevis. Foreign laws, including U.S. laws, have no application in Nevis. Therefore, in order to pursue a claim against assets in Nevis, whether held by a trust or otherwise, a claim must be tried in a Nevisian court, with Nevisian attorneys. As indicated above, a creditor wishing to challenge a transfer to a trust in Nevis as being fraudulent must bring an action within one to two years, depending on circumstances as described above.

5. **Company Law.** In addition to having favorable trust law, Nevis has excellent corporate law. The 1984 Nevis Business Corporation Ordinance is modeled on the Delaware corporate statutes. Unlike documents used to form corporations in other Caribbean jurisdictions, corporations formed under the law of Nevis use terminology that is virtually identical to that which U.S. attorneys are accustomed to. For example, articles of incorporation and bylaws are used to incorporate and govern a corporation, unlike the "articles of association" and the "memorandum of association" used in other Caribbean jurisdictions. Directors and officers of a corporation are elected and operate much the same way as U.S. officers and directors of an American corporation do. A Nevis corporation is completely exempt from taxation in Nevis although a minimal $250 franchise tax is due annually with the Registrar of Companies.

   Similarly, the Limited Liability Company Ordinance 1995 was specifically drafted to qualify a Nevis LLC as a partnership for tax purposes under U.S. law and to provide a flexible entity for estate and asset protection planning.

Moreover, the Nevis limited liability company ordinance provides that the sole recourse that a judgment creditor has against a member of a Nevis limited liability company is to seek a charging order against that member's interest. The judgment creditor is only entitled to receive distributions which the member might be entitled to. If the LLC declares no distributions to the member, the creditor gets nothing. Moreover, as a result of Internal Revenue Service Revenue Ruling 77-137, a creditor who uses a charging order to attach a partner's income in a limited liability company will treat the creditor as the partner in the entity for tax purposes. Therefore, the creditor must include in taxable income the member's pro rata share of income from the company.

H. ST. VINCENT AND THE GRENADINES.

1. **Location and History.** St. Vincent and the Grenadines is located 1600 miles southeast of Miami and 100 west of Barbados. It is part of the island chain called the Lessor Antilles. It is a small island economy with a population of about 108,000 residents in an area of 368 square kilometers. The capital of St. Vincent and the Grenadines is Kingstown, located on the main island of St. Vincent, the center of business and finance. St. Vincent and the Grenadines gained independence from the United Kingdom on October 27, 1979.

2. **Government.** The islands are governed by a unicameral House of Assembly which consists of 15 elected representatives and six appointed senators. The legal system is based upon the English model including the use of common law.

3. **Trust Law.** During 1996, St. Vincent's and the Grenadines embarked on an ambitious redrafting of its laws to become a modern player in the offshore financial markets. In addition to passing modern international company legislation and banking legislation, St. Vincent and the Grenadines adopted modern trust legislation which combined the best features of international trust law from various jurisdictions. It is designed to appeal to potential clients from common law jurisdictions as well as civil law jurisdictions. The trust legislation provides for strict confidentiality of information combined with favorable asset protection legislation including freedom from forced heirship and community property laws. While fraudulent conveyances into a trust will not be condoned under the law, a truncated statute of limitations for claims as well as a high level of proof and the necessity of depositing a $25,000 filing fee for suits against the trust make pursuing such a claim against a trust in St. Vincent problematic at best.

   While the legislation is probably one of the most modern pieces of asset protection legislation in the Caribbean, St. Vincent suffered from the untimely arrest of two wealthy American tourists in 1996 who were charged with the murder of a local citizen. While the charges were later dismissed for lack of evidence, the arrest had a chilling affect on the islands' marketing efforts in the United States.

4. **Fraudulent Transfers.** The State of Elizabeth has been expressly repealed in St. Vincents and the Grenadines. Foreign judgments are not enforceable against trust property. A creditor who claims that assets have been fraudulently transferred to a trust must commence an action within two years of the date that the trust was established or the disposition took place. Moreover, the creditor will have to prove, *beyond a reasonable doubt*, that the trust was settled or the disposition was made with the intent to defraud *that creditor* and that as a result of the settlement or disposition the settlor was rendered insolvent. A creditor who seeks to bring an action or proceeding against a trust or trust property will be required to deposit with the court prior to the commencement of the action or proceeding at least $25,000 as security for costs which may be payable if the creditor is unsuccessful.

5. **Company Law.** Company law in St. Vincent and the Grenadines is provided by the International Business Companies Act. Incorporation of entities using documents in a foreign language is allowed provided that a certified translation is attached to the official documents. Shares representing ownership in the company may be both registered or bearer shares although no shareholder list or information regarding beneficial ownership of the shares is required to be made public. Company books, share registers and other corporate documents may be kept in or outside of St. Vincent. There are no limitations on where or how meetings may be held and there are no mandatory annual returns. Upon incorporation, a St. Vincent IBC receives a Government Certificate of Exemption from taxation for 25 years from the date of incorporation.

The International Business Companies Act also provides for limited liability companies which are specifically designed to act as pass through conduits for tax purposes under U.S. tax law. The companies act very much like a U.S. limited liability company including the ability to operate with a sole member.

St. Vincents and the Grenadines prides itself on being able to incorporate entities on an expedited basis, typically being able to register articles of incorporation of articles of organization within 24 hours of submission.

I. **SWITZERLAND.** Contrary to popular perception, Switzerland is not a haven for establishing an asset protection trust. In fact, the concept of a trust is not even recognized under Swiss law although Swiss courts will recognize the existence of a foreign trust if properly formed in another jurisdiction which allows such trusts. Nevertheless, Switzerland is recognized as a leader in the management of assets held by trusts formed in other jurisdictions.

Switzerland has traditionally been the location of private management accounts or secret "numbered" accounts established by American citizens wishing to evade payment of U.S. taxes on their income. It is a favorite jurisdiction for such endeavors since tax evasion is not a crime in Switzerland. Thus, since tax evasion is not a crime in Switzerland, Swiss authorities will not share information with other countries seeking to obtain information about foreign citizens who are suspected of tax avoidance in their own countries.

VII. U.S. INCOME TAX CONSIDERATIONS

Possibly the biggest myth associated with the use of an offshore trust is that its income is not subject to taxation in the United States. This misconception can probably be traced to two reasons. First, most offshore jurisdiction, such as the Cayman Islands, are "tax havens" that do not tax trusts or business entities established by non-residents in their own jurisdictions. Under the law of most tax haven jurisdictions, all income earned by a foreign trust established by a U.S. citizen is free from taxation in that jurisdiction. However, such tax free status does not mean the income is not taxable in the United States.

A second reason why offshore trusts established by U.S. citizens are incorrectly perceived to be free of taxation is that most trusts established by Americans abroad do not pay taxes to anyone; all quite illegally. A recent government report indicated that United States citizens are estimated to possess or control $650 billion in accounts established in three popular tax havens, the Cayman Islands, the Bahamas and Luxembourg.

A third and unpublicized reason for this misconception is the careless misrepresentations made by unscrupulous promoters of offshore trusts, in both the United States and offshore. Unfortunately, contrary to popular myth, the income from a foreign situs trust established by an American settlor is **not** free from taxation in the United States.

A. Typical Grantor Retained Powers in an Offshore Trust. The laws of the offshore jurisdictions which are typically used for asset protection trusts promote the concept of preservation of the settlor's wealth for the benefit of the settlor and his family and other beneficiaries. As a result, a typical offshore asset protection trust will include the following features which are extremely relevant to the treatment of the trust for United States income and estate tax purposes:

- The settlor is typically the principal beneficiary of the trust. As such, he is entitled to distributions of income and corpus from the trust.

- The settlor's children and other family members are named as members of a beneficiary class also entitled to receive benefits from the trust.

- The settlor, either unilaterally or with a consent of the protector, is entitled to name additional beneficiaries to the trust, not originally named when the trust was formed, at any time during his life.

- Upon the settlor's death, the settlor is often given the authority to exercise a limited or general power of appointment authorizing the settlor to dispose of the trust assets pursuant to his last will and testament.

As will be shown below, these typical asset protection trust attributes have a significant impact on how the trust is treated for U.S. income and estate tax purposes.

B. Grantor Trust Rules. A grantor trust is a trust whose income is taxed to the settlor of the trust as a result of certain powers or interests which the grantor may retain upon formation of the trust. For purposes of federal income taxation, the trust is totally ignored. All income and other tax attributes attributable to the grantor trust are taxed directly to the grantor.

Internal Revenue Code §§673-675 provide that trust income will be taxed to the settlor if the following circumstances are present:

1. the grantor has retained a reversionary interest in the trust, within certain time limits specified in §673 of the Code;

2. the grantor or a non-adverse party has certain powers over the beneficial interest under the trust;

3. if certain administrative powers over the trust exist under which the grantor can or does benefit;

4. if the grantor or a non-adverse party has the power to revoke the trust or return the corpus to the grantor; or

5. if the grantor or a non-adverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse.

C. Application of Grantor Trust Rules to Foreign Situs Trust. The grantor trust rules found in §671-678 of the Internal Revenue Code are specifically made applicable to foreign trusts having one or more United States beneficiaries by Internal Revenue Code §679. In general, §679(a) provides that a United States person who directly or indirectly transfers property to a foreign trust shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of the trust. §679(b) provides that if a foreign trust which did not heretofore have United States beneficiaries subsequently acquires a United States beneficiary, then, the settlor of the trust shall be treated as having income for the taxable year equal to the undistributed net income, at the close of such immediately preceding taxable year, attributable to the property transferred to the trust by the settlor.

D. Estate Tax Consequences. For much the same reasons that a typical offshore trust is treated as a "grantor trust" for income tax purposes, likewise the transfer of assets to an offshore trust will not be deemed to be a completed gift for federal gift and estate tax purposes.

1. Incomplete Gift. Treasury Regulations Section 25.2511-2(c) specifically provides that 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 interest of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. In a typical offshore asset protection trust, the settlor expressly retains the power to name new beneficiaries to the trust, thus enabling such beneficiaries to enjoy the fruits of the property transferred into the trust. The transfer of the asset to the trust is therefore expressly an incomplete gift under Treas. Reg. §25.2511-2(c).

2. Retained Life Estate. Section 2036 of the Internal Revenue Code provides that the value of the gross estate of a decedent shall include the value of all property to the extent of any interest therein of which the decedent at any time made a transfer, by trust or otherwise, under which he has retained for his life, or for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death, either (a) the possession or enjoyment of, or the right to the income from, the transferred property or (b) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. Again, in a typical offshore asset protection trust, the grantor is the primary beneficiary of the trust. In addition, he retains the right to name additional beneficiaries who may enjoy the fruits of the assets transferred into the trust. Therefore, pursuant to IRC §2036, the transfer to the trust is considered incomplete thus resulting in the property being included in the estate of the deceased settlor.

E. Taxation of Transfers to Foreign Trust. The Taxpayer Relief Act of 1997 repealed the old excise tax of IRC §1491 and adopted in its place new IRC §684 providing for the recognition of gain on certain transfers to foreign trusts and estates. However, the 1997 legislative revisions did not materially change the taxation of a typical offshore asset protection trust. Under new Section 684(a), any transfer of property by a United States person to a foreign estate or trust is treated as a sale or exchange for an amount equal to the fair market value of the property transferred. The transferor is required to recognize as gain the excess of:

1. the fair market value of the property so transferred, over

2. the adjusted basis (for determining gain) of such property in the hands of the transferor.

A critical exception to the general rule of §684(a) above is provided by §684(b) which provides that no gain will be recognized to the extent that the foreign trust is treated as a "grantor trust" under IRC §671. However, new §684(c) also provides that if a trust which is not a foreign trust becomes a foreign trust, such trust shall be treated as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust.

Of course, the situation may exist where a settlor may desire to make a "completed gift" for estate tax purposes. However, the settlor will have to pay the 35% excise tax pursuant to IRC §684 upon establishment of such a trust. That tax can be minimized or eliminated all together if "no-gain" or "high basis" assets, such as cash, are transferred to the trust upon formation. This strategy may be particularly advantageous in situations where the transferred property is expected to substantially appreciate in value.

F. 1996 Foreign Trust Amendments. The Clinton administration made several attempts, beginning in 1995, to enact sweeping foreign trust legislation. The first attempt probably would have succeeded had it not been "piggy-backed" to other non-tax legislation. The Clinton administration first announced its new proposals on February 6, 1995. The President's original legislation was included in the 1995 Budget Act which was eventually vetoed by President Clinton on December 6, 1995. The proposed legislation was also included in later budget proposals which were either defeated or vetoed by the President. The President finally succeeded in passing his proposed tax legislation by including it in the Small Business Job Protection Act of 1996.

The Act changed the definition of a "foreign trust" which can be found at IRC §7701(a)(30)(E). After an extensive comment period, the Internal Revenue Service adopted final regulations on February 2, 1999 which can be found at Treas. Reg. §301.7701-7.

1. Foreign Trust Defined. The revised IRC §7701(a)(30)(E) establishes a two-part objective test for determining, for tax purposes, whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust is treated as domestic.

a. Court Test. Under the first part of the test, in order for a trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must exercise primary supervision over the administration of the trust. The final regulations provide that the court test is satisfied if:

(i) The trust instrument does not direct that the trust be administered outside the United States;

(ii) The trust in fact is administered exclusively in the United States; and

(iii) The trust is not subject to an automatic migration provision or "flee" clause.

The regulations also define "primary supervision" to mean that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. The regulations acknowledge that a court may have primary supervision notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary or trust property. The term "administration of the trust" is defined to mean the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trusts from suits by creditors, and determining the amount and timing of distributions.

b. **Control Test**. Under the second part of the new test, for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. The term "substantial decisions" is defined by the final regulations to mean those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions. Substantial decisions include, but are not limited to, decisions concerning:

(i) Whether and when to distribute income or corpus;

(ii) The amount of any distributions;

(iii) The selection of a beneficiary;

(iv) Whether a receipt is allocable to income or principal;

(v) Whether to terminate the trust;

(vi) Whether to compromise, arbitrate or abandon claims of the trust;

(vii) Whether to sue on behalf of the trust or to defend suits against the trust;

(viii) Whether to remove, add or replace a trustee;

(ix) 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

(x) Investment decisions; however, if a United States person under Section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

The term "control" is defined to mean 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. Under the new regulations, to determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

2. **Information Reporting Requirements**. The Act expanded the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The Act requires the "responsible parties" to file information returns with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements will result in increased monetary penalties.

a. **Report of Transfers to Foreign Trust**. The Act requires the grantor, transferor or executor (i.e., the "responsible party") to notify the Treasury Department upon the occurrence of certain reportable events. The term "reportable event" means the creation of any foreign trust by a U.S. person, the direct and indirect transfer of any money or property to a foreign trust, including a transfer by reason of death, and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. A reportable event does not include any transfer of property to a foreign trust in exchange for consideration of at least the fair market value of the property. Also excluded are transfers to certain pension trusts, nonexempt employees' trusts described in section 402(b), and charitable trusts. The required return provides information regarding the amount of money or other property transferred to the trust, the identities of the trustee and beneficiaries of the foreign trust, and other items as prescribed by the Secretary of the Treasury.

Any U.S. person that receives (directly or indirectly) any distribution from a foreign trust is also required to file a return to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe. In cases where adequate records are not provided to the Secretary of Treasury to determine the proper treatment of any distributions from a foreign trust, the distribution is includable in the gross income of the U.S. distributee and is treated as an accumulation distribution from the middle year of a foreign trust (i.e., computed by taking the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution, unless the foreign trust elects to have a U.S. agent for the limited purpose of accepting service of process (as described below).

The information required to be filed by the "responsible party" has been incorporated into Form 3520 "Annual Return To Report Transactions With Foreign Trusts And Receipt of Certain Foreign Gifts". Form 3520 is due on the date that the responsible party's income tax return is due, including extensions. A copy of Form 3520 is attached to the responsible party's income tax return. In addition, a copy of Form 3520 must be filed with the Internal Revenue Service Center in Philadelphia, Pennsylvania.

b. **Annual Foreign Trust Report**. A U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files an annual return to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury. In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or to take testimony, and any summons for such records or testimony, in connection with the tax treatment of any items related to the trust, the Treasury Secretary is entitled to determine the tax consequences of amounts to be taken into account under the grantor trust rules (Internal Revenue Code Sections 671 through 679). This limited agency relationship is not intended to constitute an agency relationship for any other purpose under Federal or State law.

The annual information reporting requirement is satisfied for foreign trusts by filing Form 3520-A on or before the 15th day of the ***third month*** after the end of the trust's tax year. Extensions of time to file Form 3520-A are available on Form 2758.

In order to authorize a U.S. person to act as an agent under IRC §6048(B), the trust and the agent must enter into a binding agreement substantially in the format shown below, which is attached to Form 3520-A:

AUTHORIZATION OF AGENT

[Name of foreign trust] hereby expressly authorizes [name of U.S. agent] to act as its agent solely for purposes of sections 7602, 7603, and 7604 of the Internal Revenue Code with respect to any request to examine records or produce testimony related to the proper treatment of amounts required to be taken into account under the rules of section 6048(b)(1)(A) or to any summons for such records or testimony. I certify that I have the authority to execute this authorization of agent to act on behalf of [name of foreign trust].

Signature of trustee (title) (date)
(or other authorized person)

Your Name (type or print)

Identification Number (if any)

Address

[Name of agent] accepts this appointment to act as agent for [name of foreign trust] for the above purpose. I certify that I have the authority to execute this authorization of agent to act on behalf of [name of foreign trust] and agree to accept service of process for the above purposes.

Signature of agent (title) (date)

Your Name (type or print)

Identification Number (if any)

Address

3. **Monetary Penalties for Failure to Report**. Under the Act, a person that fails to provide the required notice or return in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, is subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities will result in an initial penalty equal to 5 percent of the gross reportable amount.

In cases involving a transfer of property to a foreign trust, the gross reportable amount is the gross value of the property transferred. In cases involving the death of a U.S. citizen or resident whose estate includes any portion of a foreign trust, the gross amount is the greater of: (a) the amount the decedent is treated as owning under the grantor trust rules or (b) the value of the property includable in the gross estate of the decedent. In cases where annual reporting of trust activities is required, the gross reportable amount is the gross value of the portion of the foreign trust's assets treated as owned by the U.S. grantor at the close of the year, and in cases involving a distribution to a U.S. beneficiary of a foreign trust, the gross reportable amount is the amount of the distribution to the beneficiary. An additional $10,000 penalty is imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury Department notifies the responsible party of such failure. The same penalties are applicable to a failure to report (as required by present law) certain transfers to other foreign entities. Such penalties are subject to a foreign cause exception. The House Committee Report contemplates that the reasonable cause standard will be satisfied upon the showing of reasonable efforts to comply with the reporting requirements. In no event will the total amount of penalties exceed the gross reportable amount.

The reporting requirements and applicable penalties generally apply to reportable events occurring or distributions received after the date of enactment. The annual reporting requirement and penalties applicable to U.S. grantors apply to taxable years of such persons beginning after December 31, 1995.

4. Consequences of Foreign Trust Designation. As discussed above, IRC §684(b) provides that no gain or loss will be recognized upon the transfer of assets to an offshore foreign trust so long as the foreign trust still qualifies as a "grantor trust" for federal income tax purposes. Since a typical asset protection trust established under foreign law includes extensive powers retained by the settlor of the trust, such trust will continue to be treated as "grantor trusts" for federal income tax purposes. Thus, should a foreign asset protection trust be classified as such under the new act, the only consequence will be the necessity to comply with the reporting requirements promulgated under the new act. However, those reporting requirements are only designed to insure compliance with U.S. income tax laws which a U.S. settlor should already be complying with.

G. Tax Deferral Using Foreign Non-Grantor Trusts. A significant exception to the "tax neutral" treatment of an offshore trust is a foreign "non-grantor" trust. A foreign non-grantor trust is one that is established outside the United States by a U.S. resident or citizen. It is an irrevocable trust in which the grantor makes a "completed gift" for gift and estate tax purposes. However, in order to be treated as foreign non-grantor for U.S. tax purposes, the trust must not have any U.S. beneficiaries during the life of the settlor and the settlor's spouse, and for a period of one year thereafter. During this time period, the foreign non-grantor trust may have foreign beneficiaries and will typically have at least one foreign charitable organization as a beneficiary. However, during the life of the settlor and the settlor's spouse and for a period of one year after their death, a foreign non-grantor trust will almost always accumulate all income and capital gains and not make any distributions until such time as U.S. beneficiaries are eligible to receive distributions beginning one year after the last to die of the settlor and the settlor's spouse.

1. Offshore Income Not Taxed. The income and estate tax advantages of a foreign non-grantor trust are significant. The foreign non-grantor trust is treated as a "non-resident alien" for United States income tax purposes. Therefore, as such, the foreign non-grantor trust will be taxed only on its U.S. source income. Moreover, if the non-grantor trust is not active in a U.S. trade or business, the capital gains generated within the United States will not be taxable to the trust. If the foreign non-grantor trust has no U.S. source income, it is possible to accumulate income and capital gains from foreign sources tax free (assuming the income is earned in a tax free jurisdiction such as the Cayman Islands).

2. Controlled Foreign Corporation Rules Avoided. Another significant benefit of a foreign non-grantor trust is the ability to avoid the "controlled foreign corporation" rules applicable to corporations controlled by U.S. persons. During the period in which the foreign non-grantor trust does not have any U.S. beneficiaries, it will be treated as a non-resident alien and therefore not subject to the controlled foreign corporation rules. As such, the foreign personal holding company income earned by the foreign corporations owned by the foreign non-grantor trust will escape taxation in the United States as earned.

3. Foreign Irrevocable Life Insurance Trust. A typical use of a foreign non-grantor trust is the establishment of a foreign irrevocable life insurance trust. The settlor will typically make gifts of cash to the foreign irrevocable life insurance trust much the same way as is done with a domestic insurance trust. Should the settlor so elect, the generation skipping tax ("GST") exemption can be applied to the insurance premiums. Upon the death of the settlor, the entire insurance proceeds will be excluded from the settlor's estate for estate tax purposes. Moreover, if the settlor allocated a portion of his GST exemption to all of the gifts made to the foreign insurance trust, the life insurance proceeds payable upon the death of the settlor will also be free from GST tax.

4. Taxation of Beneficiaries in U.S. To be treated as a foreign non-grantor trust, the trust may not have any U.S. beneficiaries during the life of the settlor or the settlor's spouse, or for a period of one year after their deaths. Once the foreign non-grantor trust acquires eligible U.S. beneficiaries, distributions made to those beneficiaries are taxable in the same manner as distributions from a domestic non-grantor trust. However, any appreciation in the value of the foreign non-grantor trust will have been excluded from the Settlor's estate for federal estate tax purposes.

VIII. BANKRUPTCY AND FRAUDULENT CONVEYANCE ISSUES

The asset protection planning strategy referenced in this paper assumes that the attorney and client are both satisfied their activities do not involve any attempts to hinder, delay, or defraud any existing creditor of the debtor. However, if the client has been less than honest to the attorney, or if the attorney has totally failed to dissuade the client from engaging in fraudulent transfers, a multitude of tools are available to both a creditor and a bankruptcy trustee, to set aside an alleged fraudulent transfer conveyance. The bankruptcy and fraudulent conveyance remedies available to creditors and bankruptcy trustees all have strict statute of limitation restrictions which are applicable under U.S. law. In the event that the conveyances have been made to an offshore entity, it will be necessary to look at the applicable fraudulent conveyance provisions of that jurisdiction to determine whether it will be possible to enforce a fraudulent conveyance action in the United States against an individual or entity located in a foreign jurisdiction, particularly when the U.S. court does not have personal jurisdiction over the foreign entity.

A. Bankruptcy Fraudulent Transfer Provisions. Section 548 of the United States Bankruptcy Code provides that the trustee may set aside any transfer of an interest of the debtor and property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the Petition, if the debtor voluntarily or involuntarily—

1. made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

2. [A] received less than a reasonably equivalent value in exchange for such transfer or obligation; and

[B](i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

Section 548(b) provides that the trustee of a partnership debtor may avoid any transfer of an interest of the debtor and property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the Petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

If a transfer is made or obligation incurred more than one year prior to bankruptcy, the trustee must rely upon his/her rights under the fraudulent conveyance statutes of the debtor's home state. The trustee is entitled to rely on such state provisions under §544(b) of the U.S. Bankruptcy Code. This is particularly helpful to a U.S. Bankruptcy Trustee since most fraudulent transfer state statutes provide for a four-year statute of limitation period, rather than the one year period provided by bankruptcy law.

B. Texas Uniform Fraudulent Transfer Act. The various fraudulent conveyance statutes were codified by the Texas Legislature in 1987 when Texas adopted the Texas Uniform Fraudulent Transfer Act found in Tex. Bus. & Com. Code Ann., §24.01 *et. seq*. (Vernon 1987 and Supp. 1996). In reviewing the provisions of the Act, it is important to note that relief under the act may be sought by either a creditor or a trustee in bankruptcy. More importantly, different types of creditors have different standing to bring an action under the act. The statute of limitation applicable to transfers also varies depending on the nature of the transfer.

1. Transfer Fraudulent as to Present and Future Creditors. Section 24.005 of the Act provides that a transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or within a reasonable time after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

a. with actual intent to hinder, delay, or defraud any creditor of the debtor; or

b. without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(1) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(2) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

In determining actual intent under Subsection (a)(1) of the Act, consideration may be given, among other factors, to whether:

a. the transfer or obligation was to an insider;

b. the debtor retained possession or control of the property transferred after the transfer;

c. the transfer or obligation was concealed;

d. before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

e. the transfer was of substantially all the debtor's assets;

f. the debtor absconded;

g. the debtor removed or concealed assets;

h. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

i. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

j. the transfer occurred shortly before or shortly after a substantial debt was incurred; and

k. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

2. Remedies of Creditors. Assuming a fraudulent conveyance has occurred, §24.008(a) of the Act provides that an aggrieved creditor may obtain:

a. avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim;

b. an attachment or other provisional remedy against the asset transferred or other property of the transferee in accordance with the applicable Texas Rules of Civil Procedure and the Civil Practice and Remedies Code relating to ancillary proceedings; or

c. subject to applicable principles of equity and in accordance with applicable rules of civil procedure;

(1) an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property;

(2) appointment of a receiver to take charge of the asset transferred or of other property of the transferee; or

(3) any other relief the circumstances may require.

3. If a creditor has obtained a judgment on a claim against the debtor, the creditor, if the court so orders, may levy execution on the asset transferred or its proceeds.

C. Conversion of Non-Exempt Property. Texas law specifically provides that a debtor may not acquire, obtain an interest in, make improvement to, or pay an indebtedness on *personal* property which would be exempt under Chapter 42 of the Texas Property Code with the intent to defraud, delay, or hinder an interested person from obtaining that to which the interested person is or may be entitled, the property, interest, or improvement acquired, is not exempt from seizure for the satisfaction of liabilities. If the property, interest, or improvement is acquired by discharging an encumbrance held by a third-party, a person defrauded, delayed, or hindered is subrogated to the rights of the third-party. A creditor may not assert a claim under the foregoing provision more than two (2) years after the transaction from which the claim arises. However, a person with a claim that is unliquidated or contingent at the time of the transaction may not assert a claim under this section more than one (1) year after the claim is reduced to judgment. In any event, it is a defense to a claim under §42.004 that the transfer was made in the ordinary course of business by the person making the transfer.

D. Fraud on Spouse

The Family Code sets forth the general rules governing community property and specifies the types of community property that are subject to a spouse's sole management, control, and disposition.[4] The purpose of this statute is to eliminate the unilateral conveyance and virtual representation of one spouse's community property interests by another. Thus, when joint management community property is involved, the husband and wife are joint managers and neither spouse may virtually represent the other. However, virtual representation of one spouse by the other may still be

4 Tex.Fam.Code Ann. §3.102

permitted under the statute creating a presumption of sole control where property is held in one spouse's name.

With the exception of community property over which one spouse has the sole management, control, and disposition, the community property is subject to the joint management, control, and disposition of the husband and wife, unless the spouses provide otherwise by power of attorney in writing or other agreement. During marriage, property is presumed to be subject to the sole management, control, and disposition of a spouse if it is held in his or her name, as shown by muniment, contract, deposit of funds, or other evidence of ownership, or if it is in his or her possession and is not subject to such evidence of ownership.[5] During marriage, each spouse has the sole management, control, and disposition of the community property that he or she would have owned if single, including but not limited to, the following:

- personal earnings
- revenue from separate property
- recoveries for personal injuries
- The increase and mutations of, and the revenue from, all property subject to his or her sole management, control, and disposition.[6]

Community property over which a spouse has the sole management, control, and disposition is known as special community property.[7] Special community property is that portion of the community that is under one spouse's exclusive control and is not liable for the other spouse's debts.[8] It is not necessary that one spouse approve or agree with dispositions made by the other spouse of that spouse's special community property.[9]

In the absence of fraud on the other spouse, a managing spouse has the sole right of control and disposition of the community property as he or she sees fit and need not obtain approval or agreement of the other spouse to dispositions of the managing spouse's special community property.[10] Though it is unnecessary for a managing spouse to obtain the approval or agreement of the other spouse to dispositions of the managing spouse's special community property, a trust relationship exists between a husband and wife as to that portion of the community property controlled by the managing spouse and a presumption of fraud arises when a spouse unfairly disposes of the other spouse's one-half interest in the

5 Tex.Fam.Code Ann.§3.104(a)

6 Tex.Fam.Code Ann §3.102(b)

7 Moss v. Gibbs, 370 S.W.2d 452 (Tex. 1963).

8 Id.

9 Tabassi v. NBC Bank-San Antonio, 737 S.W.2d 612, 617 (Tex. App.—Austin 1987, ref. n.r.e.).

10 Mazique v. Mazique, 742 S.W.2d 805, 807 (Tex. App.—Houston [1st Dist.] 1987).

community.[11] While the managing spouse may make moderate gifts for just causes to persons outside the community, a gift of community funds that is capricious, excessive, or arbitrary may be set aside as constructive fraud on the other spouse.[12] In considering the fairness of a gift or disposition of community funds to a third party by the managing spouse, a court may look to the relationship between the managing spouse and the person to whom the gift was made, whether there were any special circumstances tending to justify the gift, and whether community funds used for the gift were reasonable in proportion to the community estate remaining; similarly, where the managing spouse has received community funds and the time has come to account for those funds, the managing spouse has the burden of accounting for their proper use.[13]

The "fraud on the community" or "fraud on the spouse" doctrine is a judicially created concept based on the theory of constructive fraud; "constructive fraud" is the breach of a legal or equitable duty which violates a fiduciary relationship, as exists between spouses.[14] A gift of a spouse's share of community property will be set aside and constructive fraud found, where the gift is unfair to that spouse.[15] It is not necessary when proceeding under a theory of constructive fraud against a spouse's share of the community estate by virtue of gifts of community property by the other spouse, that the spouse claiming fraud establish fraudulent intent.[16] Each case of claimed constructive fraud against a spouse's share of community estate by virtue of gifts of the community property by the other spouse will necessarily turn on the facts presented.[17] If the managing spouse violates his or her duty to the other spouse, a personal judgment for damages may provide a means for recoupment of the value lost to the community as a result of constructive fraud.[18]

The transfer of community property assets by a spouse to an offshore trust may be categorized as "fraud on the spouse" if done without the joinder and/or consent of the non-transferring spouse. A properly structured offshore asset protection trust will provide one of two alternatives to avoid this problem. The most common solution is to have a "divorce clause" in the agreement which provides that, upon the divorce of the parties, the asset protection trust will be divided into two separate trusts for the benefit of each spouse pursuant to an order issued by the divorce court. Another alternative is to obtain the informed consent of the non-transferring spouse at the time that the trust is established. Failure to address this potential problem will create serious issues for all involved upon the divorce of the parties.

IX. MONEY LAUNDERING TRAPS FOR THE UNWARY

[11] Id.
[12] Id. at 808.
[13] Id.
[14] Jackson v. Smith, 703 S.W.2d 791, 795 (Tex. App.—Dallas 1985).
[15] Tabassi, 737 S.W.2d at 617.
[16] Id.
[17] Id.
[18] Mazique, 742 S.W.2d at 808.

The Money Laundering Control Act of 1986 was adopted by Congress in response to the enormous problem of money laundering involving proceeds of illegal drug trafficking. The provisions of the Act are found in Sections 1956 and 1957 of Title 18 of the United States Code. Since its initial enactment, a series of amendments to the money laundering provisions of Sections 1956 and 1957 have expanded the application of the law to a very broad range of financial transactions which have nothing to do with traditional concepts of money laundering. More importantly, the law provides criminal sanctions for those who deal with persons or property connected with unlawful activity. This paper will focus on the potential criminal pitfalls to real estate professionals and their lawyers as a result of the application of the money laundering provisions of Federal law to real estate transactions.

A. History of Money Laundering Law. In its report entitled "The Cash Connection: Organized Crime, Financial Institutions, and Money Laundering," the President's Commission on Organized Crime defined money laundering as "the process by which one conceals the existence, illegal source or illegal application of income, and then disguises that income to make it appear legitimate." Until the enactment of the money laundering provisions of 18 U.S.C. §1956 and 1957, most money laundering prosecutions were based upon a combination of charges pursuant to the conspiracy provisions of Title 21, currency transaction reporting ("CTR") violations under Title 31, and prosecutions under the Travel Act, and Title 18 conspiracy. However, money laundering accusations using the conspiracy theory prove problematic for the government. Money laundering in and of itself was not a crime. The mere fact that a person laundered money derived from illegal drug trafficking did not make the launderer part of the conspiracy to violate narcotics law. Under law that existed prior to enactment of modern money laundering statutes, the government was required to show a sufficient link between a defendant's money laundering and the underlying illegal activity to demonstrate the defendant was a member of the conspiracy. U.S. v. Dela Espriella, 781 F.2d 1432 (9th Cir. 1986).

Likewise, under the Travel Act, the government was required to show an ongoing continuous "business enterprise" which the defendant intended to "facilitate by his actions." For example, in United States v. Lignarolo, 770 F.2d 971 (11th Cir. 1985), cert. denied 476 US 1105 (1986), the 11th Circuit Court of Appeals upheld the conviction of the defendant in the situation where he "willfully distributes proceeds that he knows were derived from an unlawful activity". The Court's holding was based in part on the language and purpose of the Travel Act which was "to control the flow of illegal profits" from narcotics activity. However, even in Lignarolo, the Court made clear that its ruling had limited application. The Court specifically noted that its holding did not encompass businessmen who provide otherwise lawful services and products to an unlawful business enterprise. The Court felt that its ruling was limited to individuals who knowingly distribute and launder proceeds of an unlawful activity as defined in 18 U.S.C. 1952 (b), a result in harmony both with the practicalities of the business community and the legislative history of the Travel Act. U.S. v. Lignarolo, 770 F.2d at 978 n. 11.

In adopting the Money Laundering Control Act of 1986, Congress intended that liability under the Act extend to both those who actually engage in the criminal activity that generates the illegal funds and to those who merely receive or otherwise handle illegal funds while providing ordinary, legitimate goods or services. At the time of its adoption, Congress was fully aware that the Act could and would be used to seek prosecution of otherwise law abiding citizens who knowingly accepted funds from illegal activity as payment for ordinary, legitimate goods or services, or who otherwise knowingly handled criminally derived funds while providing those services. In reporting the Money Laundering Control Act to Congress in 1986, the Senate Subcommittee on Crime reported to Congress that a person who engaged in a financial transaction using the proceeds of a designated offense would violate the provisions of the Money Laundering Act if such person knew that the subject of the transaction were the proceeds of any crime. The House Judiciary Committee on Crime was also well aware that every person who does business with a drug trafficker, or any other criminal, does so at some substantial risk if that person knows that they are being paid with the proceeds of a crime and then uses that money in a financial transaction. In arguing in favor of the new Act, Congressman Clay Shaw stated:

> *"I am concerned about a broker who might take a quarter of a million dollars of cash down to Fort Lauderdale taking that as payment. I am concerned about the realtor who is going to make a $50,000 or $100,000 commission on a deal by knowingly doing it. I am sick and tired of watching people sit back and say, 'I am not a part of the problem, I am not committing the crime, and, therefore, my hands are clean even though I know the money is dirty I am handling. The only way we will get at this problem is to let the whole community, the whole population, know they are part of the problem and they could very well be convicted of it if they knowingly take these funds. If we can make the drug dealers' money worthless, then we have really struck a chord, and we have hit him where he bruises, and that is right in the pocketbook .... You have outstanding business people who are otherwise totally moral who are accepting these funds and profiting greatly from drug trafficking that is going on throughout this country, and this will put a stop to it."*

Although both §1956 and §1957 of Title 18 have been called money laundering statutes, only §1956 actually criminalizes solely conduct necessarily related to an effort to conceal or disguise income. By contrast, §1957 criminalizes certain conduct without regard to whether it is part of an effort to conceal or disguise income. Although specifically adopted as part of a comprehensive money laundering control package, Congress intentionally omitted the money laundering elements from §1957 for the purpose of criminalizing a category of conduct that is completely unrelated to money laundering activity, that is, engaging in certain ordinary commercial transactions that, while involving criminally derived property, are in no way designed to conceal or disguise that property. H.R. Rep. No. 855, 99th Cong., 2d Sess. 13-14 (1986). Congress specifically intended that liability under §1957 should extend to both those who actually engage in the criminal activity that generates illegitimate funds and those who merely receive or otherwise handle illegitimate funds while providing ordinary, legitimate goods or services. In a sense, §1957 is a "money spending statute" in that it can be violated by simply knowingly spending more than $10,000 of profits of criminal activity, without any other unlawful purpose. Section 1957 is also a "money receiving statute" in that the knowing receipt or other handling of more than $10,000 of tainted funds or property, without any other unlawful purpose, can constitute a violation of §1957. 18 U.S.C. §1957(a)-(c) (1988).

The concept of attacking the criminal's activity indirectly by threatening not just the criminal but those who deal commercially with criminals was not a new concept. For example, federal law has long prohibited the sale or receipt of various types of stolen property. However, Section 1957 was revolutionary in its expanded definition of the term "criminally derived property." The term applied not only to stolen funds or those obtained by fraud, but also to a vast category of property referred to as "profits of criminal activity." From its inception, critics of the law have expressed concern with the possibility that otherwise ordinary individuals would be caught by the money laundering net of the new Act for having conducted business with individuals who "looked and acted" like criminals. Arguably, the first reported case under 18 U.S.C. §1957, discussed below, confirmed those fears.

B. Money Laundering Provisions of U.S.C. §1956

1. "Financial Transaction" Offense.

Section 1956 provides that, whoever knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specific unlawful activity (i) with the intent to promote the carrying on of a specific unlawful activity or (ii) with the intent to engage in conduct constituting a violation of Section 7201 or 7206 of the Internal Revenue Code of 1986 or (iii) knowing that the transaction is designed in whole or in part

(a) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specific unlawful activity, or

(b) to avoid a transaction reporting requirement under State or Federal law is guilty of a felony and is subject to a fine of not more than $500,000 or twice the value of the property involved in the transaction, whichever is greater, or imprisonment for not more than 20 years, or both.

2. Transportation Offenses. Subsection 1956(a)(2) is known as the "extraterritorial transportation" money laundering offense. It provides that whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside of the United States, with the intent of promoting the carrying on of specific unlawful activity or, knowing that the monetary instrument or funds involved in the transportation, transmission, or transfer represent the proceeds of some form of unlawful activity and knowing that such transportation, transmission or transfer is designed in whole or in part

(a) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specific unlawful activity, or

(b) to avoid a transportation reporting requirement under state or federal law,

is guilty of a felony and subject to a fine of not more than $500,000 or twice the value of the monetary instrument or funds involved in the transportation, transmission or transfer, whichever is greater, or imprisonment for not more than twenty years, or both.

As used in §1956, the term "transaction" includes a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition, and with respect to a financial institution includes a deposit, withdrawal, transfer between accounts, exchange of currency, loan, extension of credit, purchase or sale of any stock, bond, certificate of deposit, or other monetary instrument, use of a safety deposit box, or any other payment, transfer, or delivery by, through, or to a financial institution, by whatever means effected.

The term "financial transaction" means (a) a transaction which in any way or degree affects interstate or foreign commerce (i) involving the movement of funds by wire or other means or (ii) involving one or more monetary instruments, or (iii) involving the transfer of title to any real property, vehicle, vessel, or aircraft, or (b) a transaction involving the use of a financial institution which is engaged in, or the activities of which affect, interstate or foreign commerce in any way or degree.

A "monetary instrument" means (i) coin or currency of the United States or of any other country, travelers checks, personal checks, bank checks and money orders, or (ii) investment securities or negotiable instruments, in bearer form or otherwise in such form that title thereto passes upon delivery.

3. **Knowledge Requirement**. One element in both the transaction offenses and transportation offenses of §1956 is knowledge that "the property involved in a financial transaction represents the proceeds of some form of unlawful activity." Section 1956(c)(1) provides that the term "knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity" means that the person knew the property involved in the transaction represented proceeds from some form, though not necessarily which form, of activity that constitutes a felony under state or federal law, regardless of whether or not such activity is specified in the laundry list of "specified unlawful activity" of Section 1956(c)(7).

The legislative history to §1956 indicates that the use of the ambiguous term "some" was not accidental. As explained in the Senate's Report: "In order to fall within this section, the participant need not know that the property involved in the transaction represents the proceeds of 'specific unlawful activity.' He or she need only know that it represents the proceeds of some form of unlawful activity. This distinction is drawn in order to prevent a defendant from escaping conviction by merely alleging that he or she thought the property involved represented the proceeds of a crime not covered in the term "specified unlawful activity." It was reported to the Committee that such a defense has been successfully raised in other countries whose statutes do not draw the distinction drawn in this section and it is the Committee's intention to avoid that result."

Thus, it is not necessary that the Defendant know exactly what crime generated the funds involved in a transaction. It is necessary only that the government show that the funds are the proceeds of some kind of crime that is a felony under federal or state law.

It is equally clear that in relieving the government of proving just what the defendant knew, Congress expressly intended the term "knowing" to encompass instances of "willful blindness." The Senate Report gave the specific example of a currency exchanger who participates in a transaction with a known drug dealer involving hundreds of thousands of dollars in cash and who accepts a commission far above the market rate. Such a person cannot escape conviction from the first tier of the offense, simply by claiming that he did not know for sure that the currency involved in the transaction was derived from crime. On the other hand, an automobile car dealer who sells a car at market rates to a person whom he merely suspects of involvement with crime, cannot be convicted of this offense in the absence of a showing that he knew something more about the transaction or the circumstances surrounding it. S. Rep. 433, 99th Cong., 2d Sess. 10 (1986).

4. **<u>Specified Unlawful Activities</u>**. Although the money laundering statutes were aimed primarily at drug trafficking, it is abundantly clear that proceeds from a multitude of unlawful activities will be governed by the money laundering provisions of Title 18. The term "specified unlawful activities" is defined in §1956(b)(7) and includes an extensive list of offenses including the following:

a. generally any activity involving the illegal manufacture, importation or sale of illegal drugs;

b. financial misconduct offenses under 18 U.S.C. §152 (relating to concealment of assets);

c. false oaths and claims; bribery;

d. counterfeiting;
e. crimes relating to theft;
f. embezzlement, or misapplication of bank funds by a bank officer or employee;
g. proceeds from fraud committed against the Federal Deposit Insurance Corporation, Resolution Trust Corporation or related entities;
h. the making of fraudulent loan or credit applications;
i. the concealment of assets from a conservator, receiver or liquidating agent of a financial institution;
j. mail fraud;
k. copyright infringement;
l. any felony violation of the Foreign Corrupt Practices Act; and
m. any act or activity constituting an offense under 18 U.S.C. §1961(1) which governs "racketeering activity" or Racketeer Influenced and Corrupt Organizations (RICO).

The provisions of 18 U.S.C. Sections 1956 and 1957 will be triggered if they involved any of the "specified unlawful activities" enumerated in Section 1956(b)(7). Proceeds from drug trafficking is only one of the categories covered. For example, a bank customer who establishes a line of credit by submitting a fraudulent credit application commits an act of money laundering each and every time that he draws on that line of credit. Likewise, an individual who fraudulently induces a third party to make a wire transfer is guilty of money laundering since "wire fraud" is an offense listed as "racketeering activity" under the Racketeer Influenced and Corrupt Organizations Act (RICO). see U.S. v. Hare, 49 F.3d 447, rehearing denied, certiorari denied 116 S.Ct. 211. If an attorney knows or has reason to believe that funds in the client's possession were obtained through specific unlawful activities, the attorney's involvement with the transfer or movement of those funds may constitute a money laundering offense.

5. **Civil Penalty Provisions**. Section 1956(b) provides that whoever conducts or attempts to conduct a financial transaction involving the proceeds of specific unlawful activity, as defined in Section 1956(a)(1) or (a)(3), or is involved in the transportation, transmission, or transfer described in Subsection (a)(2), is liable to the United States for a civil penalty of not more than the greater of (i) the value of the property, funds, or monetary instruments involved in the transaction, or (ii) $10,000.00. This civil penalty provision is a powerful tool for the government in "borderline" cases since it enables the government to enforce the application of the penalty by the mere showing of a "preponderance of the evidence" rather than the stricter criminal standard of "beyond a reasonable doubt".

The civil penalty provisions of Section 1956(b) is probably a more realistic risk to attorneys and their clients than criminal sanctions. The government is aware that juries are not inclined to convict real estate professionals and/or attorneys who are otherwise law abiding citizens. The imposition of a civil penalty under Section 1956(b) allows the government to seek recourse against those who knowingly deal with persons or property connected with unlawful activity without necessarily seeking imprisonment for the otherwise lawful real estate professional.

C. FINANCIAL TRANSACTIONS INVOLVING "CRIMINALLY DERIVED PROPERTY"

1. **Elements of 18 U.S.C. § 1957 Offense**. Section 1957 provides that whoever knowingly engages or attempts to engage in a monetary transaction in criminally derived property that is of a value greater than $10,000 and is derived from specific unlawful activity, may be subject to a fine under Title 18, United States Code, or imprisonment for not more than 10 years, or both. Alternatively, the Court may impose an alternate fine of not more than twice the amount of the criminally derived property involved in the transaction.

   In a prosecution for an offense under Section 1957, the government is not required to prove that the defendant knew that the offense from which the criminally derived property was derived was specific unlawful activity.

   As used in Section 1957, the term "monetary transaction" means the deposit, withdrawal, transfer, or exchange, in or effecting interstate or foreign commerce, of funds or a monetary instrument, as defined in 18 U.S.C. 1956(c)(5) by, through or to a financial institution, including any transaction that would be a financial transaction under 18 U.S.C. 1956(c)(4)(B). A later amendment to the definition of monetary transaction attempted to clarify the fact that a "monetary transaction" does not include any transaction "necessary to preserve a person's right to representation as guaranteed by the Sixth Amendment to the Constitution."

   The term "criminally derived property" means any property constituting, or derived from, proceeds obtained from a criminal offense while the term "specified unlawful activity" has the meaning given that term in 18 U.S.C. 1956.

2. **The Relevance of Defendant's Knowledge**. A key element of a Section 1957 violation is a requirement that the defendant have knowledge of the fact

that the transaction involves "criminally derived property." The first reported case prosecuted under Section 1957 involved a real estate broker who ostensibly was indicted based upon evidence that the broker's customer "looked and acted" like a professional criminal. United States v. Campbell, 777 F.Supp. 1259 (W.D. N.C. 1991), rev'd in part, 977 F.2d 854 (4th Cir. 1992), cert. denied, 122 L.Ed. 2d 716 (1993). Ellen Campbell was a licensed real estate agent working at Lake Norman Realty in Mooresville, North Carolina. During the same period, Mark Lawling was a drug dealer in Kannapolis, North Dakota. Lawling decided to buy a house on Lake Norman and retained Ellen Campbell's services for that purpose.

Lawling represented himself to Campbell as the owner of a legitimate business, L&N AutoCraft, which purportedly performed automobile customizing services. When meeting with Campbell, Lawling would travel in either a red Porsche he owned or a gold Porsche owned by a fellow drug dealer Randy Sweatt, who would usually accompany Lawling. During the trips to look at houses, which occurred during normal business hours, Lawling would bring his cellular phone and would often consume food and beer with Sweatt. At one point, Lawling brought a brief case containing $20,000.00 in cash, showing the money to Campbell to demonstrate his ability to purchase a house.

Lawling eventually settled upon a house listed at $181,000. After entering into a written contract to purchase a house, Lawling was unable to secure a loan. He thus asked the sellers of the property to accept $60,000 "under the table" and to lower the contract price to $122,500. Lawling contacted Campbell and informed her of this proposal. Campbell relayed the proposal to the seller's broker. An agreement was reached to consummate the purchase along the lines suggested by Lawling. A new contract was necessitated by the lowered sales price and revised broker commission which had been increased in order to protect the realtor's profit on the sale.

After the contract was executed, Lawling met with Campbell, the buyer and the buyer's broker in the Mooresville sales office with $60,000 in cash. The money was wrapped in small bundles and carried in a brown paper grocery bag. The money was counted, and a new contract was executed reflecting a sales price of $122,500. Lawling then "tipped" both Campbell and the seller's broker with a couple of hundred dollars.

Ellen Campbell was indicted and charged with one count of violating 18 U.S.C. 1956, one count of violating 18 U.S.C. 1957, and one count of violating 18 U.S.C. 1001 (involving filing of a false document with a government agency).

The District Court found, and Campbell did not dispute, that there was adequate evidence for the jury to find that Campbell conducted a financial transaction which in fact involved proceeds of Lawling's illegal drug activities. The central issue in contention on appeal was whether there was sufficient evidence for the jury to find that Campbell possessed knowledge that: (a) Lawling's funds were the proceeds of illegal activities; and (b) the transaction was designed to disguise the nature of those proceeds.

In assessing Campbell's culpability, the 4th Circuit noted that the statute requires actual subjective knowledge. Campbell could not be convicted on what she objectively should have known. However, the 4th Circuit also noted that this requirement was softened somewhat by the doctrine of willful blindness. The Court then analyzed the District Court's instructions to the jury on "willful blindness" which was as follows:

> *"The element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed her eyes to what would otherwise have been obvious to her. A finding beyond a reasonable doubt of a conscious purpose to avoid enlightenment would permit an inference of knowledge. Stated another way, a defendant's knowledge of a fact may be inferred upon willful blindness to the existence of a fact.*
>
> *It is entirely up to you as to whether you find any deliberate closing of the eyes and inferences to be drawn from any evidence. A showing of negligence is not sufficient to support a finding of willfulness or knowledge.*
>
> *I caution you that the willful blindness charge does not authorize you to find that the defendant acted knowingly because she should have known what was occurring when the property at 763 Sundown Road was being sold, or that in the exercise of hindsight she should have known what was occurring or because she was negligent in failing to recognize what was occurring or even because she was reckless or foolish in failing to recognize what was occurring. Instead, the Government must prove beyond a reasonable doubt*

> *that the defendant purposely and deliberately contrived to avoid learning all of the facts."*

Neither party disputed the adequacy of the court's instructions on willful blindness or their applicability to the case.

At trial, the government prosecuted under both an actual knowledge theory and a willful blindness theory to support the indictment under Sections 1956 and 1957. The District Court entered a judgment of acquittal with respect to the money laundering violations and conditionally granted a new trial on those counts on the grounds that the evidence was insufficient to support a jury finding that Campbell knew that the funds used to buy the house were drug proceeds.

On appeal, the 4th Circuit Court of Appeals reversed the judgment of acquittal. The Court of Appeals acknowledged that the evidence pointing to Campbell's knowledge of Lawling's illegal activities was not overwhelming. However, the Court of Appeals also found that the District Court had inappropriately excluded or downplayed certain incriminating evidence. In determining whether the issue should have been allowed to proceed to jury, the Court of Appeals pointed out that the evidence showed that Lawling and his companion both drove new Porsches, that Lawling carried a cell phone, flashed vast amounts of cash, and was able to be away from his purportedly legitimate business for long stretches of time during normal business hours. Also relevant was testimony by the seller's broker that Campbell had stated prior to the sale that the funds "may have been drug money." The Court of Appeals found that the evidence of Lawling's lifestyle, the testimony concerning Campbell's statement that the money "might have been drug money," and the fraudulent nature of the transaction in which Campbell was asked to participate were sufficient to create a question for the jury concerning whether Campbell "deliberately closed her eyes to what would otherwise have been obvious to her." As a result, a reasonable jury could have found that Campbell was willfully blind to the fact that Lawling was a drug dealer and the fact that the purchase of the real property was intended, at least in part, to conceal the proceeds of Lawling's drug selling operation. Accordingly, the Court of Appeals reversed the judgment of acquittal on the money laundering charge. Likewise, on the indictment under 18 U.S.C. Section 1957(a), the Court of Appeals found that a jury could have reasonably found that Campbell knew of, or was willfully blind to, Lawling's true occupation. Therefore, it was error for the District Court to grant a judgment of acquittal on that count as well.

3. **Knowledge of "Criminally Derived Property"**. Section 1957 seeks to penalize those who knowingly engage in a transaction involving "criminally derived property" which, under subsection 1957(f)(2) is "any property

constituting, or derived from, proceeds obtained from a criminal offense." Subsection 1957(c) provides "in a prosecution for an offense under this section, the government is not required to prove that the defendant knew that the offense from which the criminally derived property was derived was a specific unlawful activity." Thus, to be convicted under §1957, the defendant need only know that the property involved in the transaction represented proceeds from some form, though not necessarily which form, of activity that constitutes a felony under state, federal, or foreign law regardless of whether or not such activity is specific unlawful activity. 18 U.S.C. §1956(c)(1). In order to obtain a conviction under §1957, the defendant does not need to know exactly what crime generated the funds involved in a transaction, only that the funds are the proceeds of some kind of crime that is a felony under federal or state law.

4. **After-Acquired Knowledge**. Section 1957(a) clearly contemplates that one must be aware of the illegal nature of the property involved at the time the monetary transaction occurs. Thus, one who engages or attempts to engage in a transaction which is later shown to have involved criminally derived property has not violated §1957. However, if knowledge of the criminal nature of the funds or property is obtained later, any further transactions involving the tainted property will clearly constitute illegal money laundering. Thus, for example, a real estate broker who receives a $10,000 earnest money deposit without knowing that the funds are criminally derived property has not committed a violation. However, if the real estate broker subsequently learns that the earnest money down payment are proceeds from criminally derived activity, any further movement of those funds would constitute a violation of the statute.

D. EFFECT ON ATTORNEY-CLIENT RELATIONSHIP

1. **Attorneys Not Immune**. The money laundering provisions of Sections 1956 and 1957 do not exempt any particular class of persons from its provisions. However, the provisions of Money Laundering Control Act from its inception created a dilemma for attorneys representing individuals who might be involved in illegal activity. A principal concern was 18 U.S.C. §1956(a)91) and 1956(c) which, if applied to an attorney who accepted a fee from a client whose money was derived from a specific unlawful activity, could be convicted of money laundering under Section 1956 upon proof that the attorney (a) knew the money was from an unlawful activity, and (b) knew that the defendant was using the attorney to conceal (by defending the client from a criminal prosecution) the unlawful activity. As initially drafted, Section 1956 contained an exemption for bona fide attorney's fees until 10 days before the President signed the Money Laundering Control Act into law. Congressman Bill McCollum initially proposed an exemption for attorneys fearing that exposing defense attorneys to prosecution for accepting bona fide but nevertheless tainted legal fees would

chill the attorney-client relationship, interfere with the attorney-client privilege, and deprive defendants of their right to representation. The House of Representatives eventually added the exemption. However, the exemption was dropped during conferences between the House and Senate. Two years later, the Money Laundering Prosecution Improvements Act of 1988 amended Section 1957 to provide that the definition of monetary transaction "does not include any transaction necessary to preserve a person's right to representation as guaranteed by the Sixth Amendment to the Constitution".

Arguably, the Sixth Amendment to the Constitution would stand on its own without the necessity of adding the attorney exemption to Section 1957. However, the exemption provides only limited protection to attorneys. First, because it is keyed to the Sixth Amendment of the Constitution, it applies only to criminal matters and does not apply until the client has been indicted. U.S. v. Gouveia, 467 U.S. 180, 191 (1984). A real estate attorney who deposits tainted funds with knowledge that the funds are tainted can face prosecution for money laundering under Section 1957.

The Department of Justice Manual includes limitations on the use of Section 1957 against attorneys. Guidelines require that the property transferred to the attorney be a legitimate fee, and not a sham designed to hide property. If this condition is met, the Department of Justice will prosecute only those attorneys who had actual knowledge that the fee was generated by crime, even if the lack of actual knowledge is due to the lawyer's willful blindness. Moreover, the lawyer's actual knowledge cannot come from confidential lawyer-client communications or the lawyer's own efforts in the course of representing the client.

2. **Forfeiture of Attorney Fees**. The forfeiture of assets is authorized by the Comprehensive Forfeiture Act of 1984. The Act amended 18 U.S.C. §1963 and added 21 U.S.C. §853. Under the Act, the government can claim title to property obtained in violation of the Racketeering Influenced and Corrupt Organizations Act (RICO). 18 U.S.C. §1961-1968. The forfeiture laws include provisions designed to stop defendants from hiding or liquidating their tainted assets. The forfeiture "relates back" to the date the crime was committed. In other words, title to the assets transfers to the government immediately upon the commission of the crime. This retroactive effect of the forfeiture that can cause problems for attorneys. The Supreme Court has ruled that criminal forfeiture laws apply to attorney's fees and that forfeiture fees is constitutional. U.S. v. Monsanto, 491 U.S. 600 (1989). If a defendant pays his lawyer with forfeitable assets, the government can recoup those fees from the lawyer. The only defense available to the lawyer is a bona fide purchaser defense. 21 U.S.C. §853(c) (1988). The lawyer must prove at a post trial hearing that at the time he received the fee, he was "reasonably without cause to believe" that the property was subject to forfeiture.

X. OTHER CRIMINAL PITFALLS FOR CLIENTS AND THEIR ATTORNEYS

If a transfer is found to be fraudulent, the evidence of actual intent to hinder, delay or defraud the creditor or the court may set the predicate for the more serious criminal action against the client and possibly his attorney. If the alleged fraudulent transfer occurred in contemplation of bankruptcy or during bankruptcy proceedings, or if the defrauded creditor was an agency of the United States Government, or if the transfer involves funds obtained through illegal or fraudulent means, the client and his attorney may find themselves facing a multitude of federal criminal statutes specifically designed to have a broad application.

A. Bankruptcy Crimes. In addition to the provisions of the Bankruptcy Code, which enables the Bankruptcy Trustee to set aside a multitude of fraudulent conveyances, 18 U.S.C. §§152 and 157 provide severe sanctions for a debtor in bankruptcy for a multitude of bankruptcy crimes and bankruptcy fraud which are found to have occurred during the bankruptcy proceeding or, in some circumstances, prior to and leading up to bankruptcy filing itself.

The general bankruptcy crime provisions of the code are found in 18 U.S.C. §152 which provides that

"a person who—

(1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;

(2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;

(5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;

(7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;

(8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or

(9) after the filing of a case under title 11, knowingly and fraudulently withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor,

shall be fined not more than $5,000 imprisoned not more than 5 years, or both.

The newly enacted bankruptcy fraud provisions are found in 18 U.S.C. §157 which provides as follows:

A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so—

1. files a petition under title 11;

2. files a document in a proceeding under title 11; or

3. makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title,

shall be fined, imprisoned not more than 5 years, or both.

Neither the provisions of §152 or §157 of the Act limit themselves to acts of the debtor. If an attorney or other professional is found to have aided and abetted the debtor in devising the scheme or artifice to defraud, the attorney may be found criminally liable for his actions.

B. Tax Crimes. It is not uncommon for attorneys to routinely advise clients who are delinquent in the payment of their federal income taxes or the filing of their federal income tax returns. Although the practitioner has an obligation to his client to fully inform the client of the consequences of such delinquencies, practitioners will sometimes come "close to the line" in advising their clients on how to shelter their assets from the Internal Revenue Service while the client works to resolve his problems. Unknowingly, the attorney may expose himself and his client to criminal prosecution for violations of provisions in the Internal Revenue Code designed to punish those who participate in transfers designed to impede the government's efforts to collect federal income taxes.

1. Removal or Concealment of Assets. Section 7206(4) of the Internal Revenue Code provides that any person who "removes, deposits, or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for on in respect whereof, any tax is or shall be imposed, or any person upon which levy is authorized by §6331, with intent to evade or defeat the assessment or collection of any tax imposed [by the Internal Revenue Code] shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation) or imprisoned not more than 3 years, or both, together with the cost of prosecution."

2. **"Corrupt or Forcible Interference."** Although initially enacted to punish those who physically threaten Internal Revenue Service agents, Internal Revenue Code §7212(a) has successfully been used by the government to prosecute attorneys who interfere with the administration of federal income tax laws. Specifically, §7212(a) of the Internal Revenue Code provides common relevant part, as follows:

> *Whoever corruptly or by force or threats of force (including any threatening letter or communication) endeavors to intimidate or impede any officer or employee of the United States acting in an official capacity under this title, or in any other way corruptly or by force or threats of force (including any threatening letter or communication) obstructs or impedes, or endeavors to obstruct or impede, the due administration of this title, shall, upon conviction thereof, be fined not more than $5,000, or imprisoned not more than 3 years, or both, except that if the offense is committed only by threats of force, the person convicted thereof shall be fined not more than $3,000, or imprisoned not more than 1 year, or both. The term "threats of force", as used in this subsection, means threats of bodily harm to the officer or employee of the United States or to a member of his family.*

An excellent example of the government's use of §7212 to prosecute attorneys is found in the case of United States v. Popkin, 943 F.2d 1535 (11th Cir. 1991). In the Popkin case, the attorney was approached by a former client and drug dealer after having been released from jail. He requested the attorney's assistance in repatriating approximately $200,000 in moneys earned by the client during 1983 and 1984 from cocaine deals while the client was in prison. The client specifically informed the attorney that his goal was to bring the funds back into the United States from their offshore account. The client also indicated an interest in paying some amount of federal income tax in order to avoid raising the suspicions of the IRS. However, the client made it very clear that he had no intention of paying the full amount of tax reportable on the $200,000 in illegal source income.

Pursuant to the client's request, the attorney established a California corporation which sold $200,000 worth of stock to a dummy offshore company which controlled the client's $200,000. Later, the stock would be repurchased from the offshore entity at a nominal amount.

As it turned out, the "client" was now working as an informer for the government. As a result, the attorney was indicted as a result of his efforts to devise a scheme to repatriate the

$200,000 in such a way as to disguise its source and the amount of the money. The indictment against attorney Popkin specifically referenced 26 U.S.C. §7212(a) by alleging that Popkin:

> *"Did corruptly obstruct and impede and endeavor to obstruct and impede the due administration of Title 26, United States Code, by preparing the tax returns described in counts 1 and 2 above and by creating a California corporation for Stephen Musick expressly for the purpose of enabling the said Stephen Musick to disguise a character of illegally earned income and repatriate it from a foreign bank."*

The attorney's defense was that it is an essential element of §7212(a) that the act or conduct of the accused involve the use of force or threats of force against the person of a particular government agent. Thus, he argued, as the government had failed in its case to prove any type of assaultive conduct or force, or any type of conduct whatsoever directed at or against a specific employee, he was entitled to a judgment of acquittal. The government argued that the plain language of the second clause of §7212(a) made it clear that force and threats of force are not required. That clause, under which Popkin admitted he was charged, made it unlawful to "in any way corruptly ***or*** by force or threats of force, obstruct or impede or endeavor to obstruct or impede the due administration of the tax laws."

After examining the meaning of the word "corruptly" as used in the statute, the 11th Circuit Court of Appeals determined that use of the word "corruptly" as used in §7212(a), was designed to prohibit all activities that seek to thwart the efforts of government officers and employees in executing the laws enacted by Congress. In reaching this conclusion, the court made the following observation:

> *"In a system of taxation such as ours which relies principally upon self-reporting, it is necessary to have in place a comprehensive statute in order to prevent taxpayers and their helpers from gaining unlawful benefits by employing that "variety of corrupt methods" that is "limited only by the imagination of the criminally inclined." Martin, 747 F.2d at 1409. We believe that §7212(a) is such a statute and that the use of "in any other way corruptly" in the second clause gives clear notice of the breadth of activities that are proscribed."*

XI. OTHER ETHICAL CONSIDERATIONS

A. Professional Standards of Conduct. No attorney should entertain the prospect of representing a client in asset protection planning without first becoming thoroughly familiar with portions of the Texas Disciplinary Rules of Professional Conduct which will affect the scope of the lawyer's responsibility in representing his/her client. Rule 1.02(c) of the Texas Rules of Professional Conduct provides as follows:

> "A lawyer shall not assist or counsel a client to engage in conduct that the lawyer knows is criminal or fraudulent. A lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel and represent a client in connection with the making of a good faith effort to determine the validity, scope, meaning or application of the law.
>
> When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in substantial injury to the financial interests or property of another, the lawyer shall promptly make reasonable efforts under the circumstances to dissuade the client from committing the crime or fraud."

The rules define "fraud" or "fraudulent" as conduct having a purpose to deceive and not merely negligent misrepresentation or failure to appraise another of relevant information. The commentary to Rule 1.02 make the following observation:

> "A lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client's conduct. The fact that a client uses advice in a course of action that is criminal or fraudulent does not, of itself, make a lawyer a party to the course of action. However, a lawyer may not knowingly assist a client in criminal or fraudulent conduct. There is a critical distinction between presenting an analysis of legal aspect of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity."

If the attorney discovers during the scope of his representation that the client has already embarked in a criminal or fraudulent scheme, the attorney must not assist the client in such endeavors and, if necessary, must withdraw from representation of the client if the attorneys continued involvement will result in violation of the disciplinary rules or law. [Rule 1.15(a)(1)].

B. **Confidentiality and the Attorney-Client Privilege**. The Texas Disciplinary Rules of Professional Conduct, Rule 1.05, defines "confidential information" to include both "privileged information" and "unprivileged client information." Privileged information is referred to as the information of a client protected by the lawyer-client privilege of Rule 503 of the Texas Rules of Evidence or of Rule 503 of the Texas Rules of Criminal Evidence or by the principles of attorney/client privilege governed by Rule 501 of the Federal Rules of Evidence. "Unprivileged client information" means all information relating to a client or furnished by the client, other than privileged information, acquired by the lawyer during the course of or by reason of the representation of the client. Under some circumstances, an attorney may reveal confidential information, such as when a crime has been committed or is about to be committed, so long as such revelation is made pursuant to the guidelines provided in the rules. Although the revelation of confidential information by an attorney, against his client's wishes, is a serious matter, it often times pales in comparison to the situation where a privileged communication between the attorney and his client is sought to be discovered by a third-party or, even worse, the U.S. Attorney's Office.

Rule 503 of the Texas Rules of Civil Procedure provides that no attorney/client privilege exists if the services of the lawyer were sought or obtained to enable or aid someone to commit or plan to commit what the client knew or reasonably or should have known to be a crime or fraud. Thus, the attorney may find themselves a subject in proceedings where a creditor may be seeking to obtain information from the attorney, including the attorney's notes and the attorney work product, involving an alleged fraud committed by his client. Because the same rule applies in criminal proceedings, it is possible that forcing an attorney to involuntary disclose information may reveal information which is incriminating to the attorney himself in addition to the client.

XII. CONCLUSION

The uncertainties of our judicial system coupled with the increased exposure to seemingly uncontrollable jury awards has resulted in attorneys re-examining the benefits associated with the establishment of a foreign situs trust for their clients. While such trust can provide a multitude of benefits, they should only be used under specific circumstances. Both the client and the attorney must be fully knowledgeable of the risks associated with the establishment of such a trust and the consequences of establishing a foreign situs trust under the wrong circumstances. Use of an offshore trust in an attempt to or as part of a scheme to defraud existing creditors will, in most cases, fail outright, and in the worst case, result in potential criminal liability to the client and the client's attorney. Nevertheless, with careful planning, the offshore trust will provide the client with significant protection against ever increasing litigation risk in today's litigious society.