OFFSHORE ASSET PROTECTION: THE IMPACT OF CHANGES IN U.S. TAXATION ON THE CHOICE OF VEHICLE

Charles A Cain[1]

For some years, the favoured mechanism of Asset Protection vehicles, that is to say, vehicles for the protection of the assets of US persons from litigious creditors, has been the offshore trust. Indeed, it had almost reached the point where nothing else was ever mentioned, in spite of the fact that there were and remain a variety of mechanisms available.

The reason for this was primarily a tax reason. The objective was to establish a vehicle into which assets could be placed which:

- protected the assets from attack through the US judicial system;
- would be able to make the assets available, if necessary, to the client and/or his family;
- would at worst be entirely tax neutral and at best enable routine Estate Tax planning to be done;
- would be inexpensive.

To achieve the first objective was comparatively simple - just get the assets out of the USA into a jurisdiction which had no Reciprocal Enforcement of Judgements Agreement. The actual holding mechanisms available then had to be selected.

The last point was also relatively simple, in that it ruled out expensive solutions such as Life Assurance policies, so that left forms of company or trust. Most

1 Charles A Cain MA, ACIB, Skye Fiduciary Services Limited, 2 Water Street, Ramsey, Isle of Man IM8 1JP. Tel: (01624) 816117 Fax: (01624) 816645.

people ignored entirely the corporate forms because of the tax implications, and concentrated entirely on trusts.

Corporate forms were ruled out because an overseas holding company was bad news for a US person. Quite apart from the enhanced reporting requirements implicit in a Controlled Foreign Corporation (CFC) with Sub-Part F income, a Foreign Personal Holding Company (FPHC), a Passive Foreign Investment Company (PFIC) and the other implications of being caught up in Professor Harvey Dale's renowned five-armed Pentapuss (now six-armed with the addition of the PFIC), there is a distinct penalty provision in relation to Capital Gains Tax.

For a CFC, on the death of the US shareholder, certain punitive rules apply in relation to basis step-up (ss.1246(e) and 1291(e)). For the layman, *basis* is the base value of the asset for Capital Gains Tax purposes. *Step-up* is the increase of the basis which occurs when the asset is sold or transferred to another party, and which triggers off the Capital Gains Tax liability (or "causes the liability to be recognised"). On the death of a US person, his estate is subject to Estate Tax, and Capital Gains Tax is forgiven, thereby providing a tax free *basis step-up*. In respect of holdings in a CFC, there is no such forgiveness, and this could easily result in the tax payable being greater than the value of the assets.

So the use of companies was ruled out. A pity, however, because even before the days of the *Check-the-Box Regulations* of 1st January 1997, it was always possible to design an exotic entity which could be a company in law, but something else for US tax purposes. Guarantee companies, for example, lent themselves well to this type of design work.

In those days too, the Limited Liability Company (LLC) as it has evolved in the USA, did not exist. Today, such forms exist in every state of the USA, as well as many other jurisdictions, often masquerading under other names as Limited Life Companies (LLC), or Limited Duration Companies (LDC), or, as in Barbados, as the Society with Restricted Liability (SRL). Patrick Taylor has recently analysed in *The Offshore Taxation Review* in detail the new Isle of Man version of the LLC; other versions differ in detail but not in principles.

Limited Partnerships were another vehicle which was used extensively inside the USA, but in those days few offshore jurisdictions had them. It is only in the last few years that every month has brought news of yet another offshore island proudly proclaiming that it has introduced the Limited Partnership (although some have had them for years; the Isle of Man, for example, since 1909). But Limited Partnerships seemed to be uncertain in their effectiveness.

Many US Practitioners then looked at Trusts for Asset Protection. They found that there was a rich tradition of Trusts being used for 'Asset Protection' in a more general sense - indeed, there is scarcely any other purpose for a Trust. For tax purposes, they were brilliant, since a trust established by a US person which he was also capable of benefiting from was a so-called *Grantor* Trust, and therefore entirely disregarded by income tax rules. Thus the offshore trust was neutral, but was still capable of being structured for basic estate tax planning.

There were, of course, some drawbacks. Firstly, the establishment of a foreign Trust, even though a Grantor Trust, led to enhanced reporting. This could, in theory, be cured, by providing as a joint trustee, a US trustee, who would resign the moment the heat was turned up, but who, until that time, enabled the trust to argue that it was a US trust for tax purposes, notwithstanding that the proper law was overseas, as were the assets and the actual management.

The second drawback was the desirability of having a holding company below the trust. Such a company immediately plunged us back into the CFC problem. There were three solutions to these CFC problems. Either the assets were transferred direct into a bank 'street' name or nominee company. Or they were held in a US corporation which, because of the tax attribution back to the Grantor, could be a transparent S-corporation, or, thirdly, the assets were held in a foreign corporation which, although owned by the Trustee, was arguably a nominee company, relying on the decision in *Commissioner v Bollinger* 108 S.Ct 1173(1988).

None of these were very satisfactory. Not all assets can be held in a "street name". The use of a US S-corporation immediately brought the assets back into the USA, where they could be frozen and/or sequestrated. The use of a nominee company correctly made it impossible to use the company as a mechanism for the day-to-day management of the assets by the client.

The problem remained until the advent of the offshore LLC, which, by being classified as a partnership instead of a corporation, enabled the Tax Transparent trust to have a Tax Transparent LLC beneath it, with the client as Manager of the LLC.

Other problems derived from the fundamental character of trust law itself, and from the so-called 'Statute of Elizabeth'. The most serious problem of all was perceived to be the issue of fraudulent transfer, and this remains the biggest problem for a foreign trustee. Under normal English Common Law principles, the principles set out in the so-called Statute of Elizabeth (Fraudulent Conveyances Act 1571 (13 Eliz I Cap 5) now contained in the UK's Insolvency Act 1986) have been adopted in one way or another by every country which looks to England for the source of its law (in the USA, the Uniform Fraudulent Transfer Act 1984). This is not, technically, a matter of trust law, but is a matter of bankruptcy law. Where a person effects a transfer to a trust with the intent to defeat any future creditor, the transfer can be set aside and the trust declared void.

Virtually every jurisdiction which had adequate equity-based trust law (anything else was and is far too risky in terms of dealing with the unknown) had also absorbed the principles of the Fraudulent Conveyances Act 1571 (13 Eliz I Cap 5). Even in the Isle of Man, where there has been no legislation, and the only authority is an obiter dicta (*Re Corrin Bankruptcy - Kermode Trustee of Corrin's Bankruptcy v Craig* (1908) (unreported) - obiter dicta per Deemster Kneen CR), the argument has continued, although the consensus now appears to be that Deemster Kneen (a *Deemster* is a High Court Judge in the Isle of Man) was wrong.

In any event, the risk was too great, not only for the client but for the trustee, and so very quickly a number of jurisdictions legislated to define the situation and ring-fence the provisions of the Statute. This, however, has led to further problems, in that in the more extreme legislation, such as that of the Cook Islands and one or two others (Nevis, for example), the legislation has created a fundamental conflict in equity. This conflict is seen in the recent *Orange Grove* case in the Cook Islands (*515 South Orange Grove Owners Association and Others v Orange Grove Partners and Others* (1995) No 208/94). At the heart is the dictum that a plaintiff must come to the Court with clean hands. Equity is about remedies, and Equity cannot be used to deny Equity to another. The efforts of the judges in the *Orange Grove* case to enforce Equitable principles in the face of legislation that apparently removed them is impressive. The bending over backwards is up to Olympic Gymnastic standards!

Another problem that was completely ignored too was the question of whether a Court in one country has jurisdiction notwithstanding that the proper law of the trust, and, indeed, even the trustee, may be in another jurisdiction. The fundamental principle of equity has long been well understood. Trusts are matters in personam, and relate to the disposition of property. If the property is largely in a specific country, and the parties to the trust are in that country, the court in that country has jurisdiction. In *Duttle v Bandler Kass* (1992) 82 Cir. 5084 (KMW), the principle was taken a little further. In that case, the Liechtenstein trustee declined to appear in a New York court. The judge considered that it would be **inequitable** to allow this to stand in the way of the court hearing the case, and thus the absence of the trustee was ignored.

The lesson in these cases is clear. Trusts are enforced through equity. Equity is NOT the same as Common Law and NOT the same as Statute Law, and anything that goes against equitable principles will be struck down by the courts.

All this has created even more uncertainty than there was before. At least in those Unreconstructed offshore jurisdictions, the issue is simple. Has there been fraud?

Then, in August 1996, the USA enacted the Small Business Jobs Protection Act 1996, which, under the wing of a fairly innocuous piece of social security legislation, fundamentally altered the tax rules relating to offshore Grantor Trusts. As far as Asset Protection Trusts are concerned, it abolished the charade of the foreign trust being a 'US Trust' for tax purposes, and thereby forced the reporting regime for foreign trusts on all offshore Asset Protection Trusts. It also greatly enhanced that reporting regime, including a requirement on the offshore trustee to provide information, and to appoint an agent in the USA for that purpose. This latter has caused real difficulties in situations where there are beneficiaries resident outside, as well as inside, the US tax net.

Finally, the Check-the-Box Regulations that came into force on 1st January 1997 changed the whole classification mechanism for entities, and thus the arguments that had been stitched together in favour of the use of the offshore Asset Protection Trust all came apart.

So where do we now stand? Under Check-the-Box Regulations, the first question is whether the entity is included in the so-called 'per-se' list of entities. If it is, then its classification is clear, and carved in stone. If it is not on the list (and virtually no offshore entities are), then the question is whether the entity is for the purpose of conserving and preserving assets. If it is, and if it has no commercial objectives that imply commercial risk, then it is a trust for tax purposes, no matter what its legal form may be.

If it does have commerciality, then if all its members have unlimited liability, the entity is a default partnership, and if this is not the case, it is a default corporation. However, in both cases, there is provision for the entity to **elect** to be treated otherwise. Thus a commercial LLC will be a default corporation, but can elect to be treated as a partnership.

All these changes have fundamentally altered the logical argument which led to the Trust as the favoured vehicle in the first place. It will be recalled that the objectives were firstly to take the assets out of the reach of the US judicial system. This can be done by using a number of entities, which are NOT trusts. For example, a Liechtenstein *Anstalt*, an Isle of Man Guarantee Company, or an offshore LLC can all do the job. All three can also make the assets available to the client or his family, if necessary.

From a tax point of view, all three could be classified as Trusts for US tax purposes, or, indeed, as partnerships. None would be able to provide Estate Tax planning, but all can provide Asset Protection characteristics, with the LLC coming out top in this regard.

If, then, we can acquire tax transparency **without** having to use an actual Trust, why use one? We have already noted the knots in which certain jurisdictions have tied up their trust law, so as to make it unreliable at best and dangerous at worst. We have already noted that the application of the rules of equity to Asset Protection can have some unforeseen consequences. Would we not be better off looking at a Quasi-Trust, or an entity, which while not actually being a trust, can nonetheless in the vital aspects provide the same effects?

Companies, although in origins derived from trust law, are creatures of Statute. And an LLC is absolutely a creature of Statute. Thus these complexities of Equity simply do not arise in interpreting how Companies or LLCs operate. We now, therefore, have three available forms. The Liechtenstein *Anstalt* is fine for those who understand Germanic type law. For those who do not understand it, the two English-speaking forms of the Guarantee Company or the LLC are preferable. As between these latter two, the Guarantee Company is infinitely more flexible and sophisticated, but entirely unknown in the USA. Persuading an Attorney in the USA to use a Guarantee Company (or its sibling, the so-called *Hybrid* company) is often very difficult, as many have great difficulty in getting their minds around the concept of a company with members who have no shares, who may have no distribution rights, or votes! However, the LLC is well understood. After all, it was the Americans who invented the LLC. So we will now concentrate exclusively on the LLC, as an Asset Protection vehicle.

There are some difficulties with using the LLC. One that we have already noted is the inability to do Estate Tax Planning. But if the LLC is going to be characterised as a Trust for tax purposes, then there is no harm in having an actual trust on top of it, **solely** of course, for the tax planning. The trust will have **absolutely no function** whatever in the context of asset protection.

Let us assume that it is desired to use an Isle of Man LLC as an Asset protection vehicle for a person with $5 million to protect.

The client with the assets to protect will establish a foreign Revocable Trust. As noted, this provides **no Asset Protection** features whatever, and is there solely to provide a vehicle through which basic estate tax planning can be done. Being revocable, it will be treated as an incomplete gift for US income and capital gains tax, and is thus wholly tax neutral for those purposes. The establishment of the Trust would not give rise to the recognition of capital gain on any assets inserted into it.

For use as an Asset Protection mechanism, the LLC would be set up with three Members. Two of these would be companies in the Isle of Man beneficially owned by a Trust Corporation (the two *Offshore Members*). Each would have a 0.05% interest ($2,500), which they would effectively hold in trust for the client.

The Third Member would be the Trustee of the Revocable Trust established by the US Client. This Trustee would have a 99.9% interest. The injection of the assets would cause capital gain to be recognised on any appreciated assets so injected.

The LLC will be established with an Operating Agreement provision that says all decisions must be by unanimous vote. We can also, optionally, include provisions that state:

- no assignment of a Member's interest will be permissible;
- there may be no distributions during the life of the LLC.

There will also be a provision that says that distributions to Members need not be in cash, but may be in any form that is unanimously agreed by the members.

Immediately after the establishment of the LLC, the three members (and the US client as beneficiary of the trust) agree that, in the event of any one resigning or retiring from membership and the remaining members resolving to continue the LLC, the interest of the retiring member shall be purchased by the remaining members by means of a Promissory Note the amount of which shall be fixed at the date of such retiral, carrying interest at 1% per annum, payable on the dissolution of the LLC, or at any time during the lifetime of the LLC at the discretion of the LLC, but in any event not later than fifteen years after the date of the Note. This would mean that the assets would be locked in for at least a further fifteen years.

There should also be a side agreement between the remaining members and the retiring member to the effect that provided that the Promissory Note is still beneficially owned by the retiring Member or his estate at that time, in the event of the dissolution of the LLC, or the death of the retiring member, or in the event that the full 15 years is run, the remaining members will buy back the Promissory Note on or as at the day before such dissolution, death or maturity date, at a price reflecting the value that would have accrued to the retiring member at such time, had he not retired. This ensures that the retiring member will eventually get his full value. If the retiring member or his estate assigns or otherwise ceases to be the beneficial owner of such promissory note, the side agreement is automatically terminated and of no effect. The two *Offshore Members* would, before this happens, have entered into another agreement with the retiring Member or his appointee, providing severance compensation for loss of office as Manager of the LLC.

From the tax viewpoint, the LLC will be exempt from tax in the Isle of Man. For US Income and Capital Gains Tax purposes, the Revocable Trust is wholly transparent. For US tax purposes, the US client will be treated as the beneficial member of the LLC.

The LLC itself will normally also be considered as a Grantor Trust, and thus also wholly transparent. However, if it is clearly stated in the Memorandum of Organisation of the LLC that the LLC is established by the Members for the purpose of carrying on a trading and commercial business and for the eventual division of the profits derived therefrom between the members, this should be sufficient for the LLC to be classified as an 'Association' for US tax purposes. It will then elect to be taxed as a partnership. In consequence, the LLC will be tax transparent as a partnership.

Either way, the US Client will be taxed on the whole of the taxable events in the LLC.

So how have we met our criteria?

The LLC is an Isle of Man legal entity created under the Limited Liability Companies Act 1996. It is not a Trust. No US court will have jurisdiction. Only the Isle of Man Courts have jurisdiction. An order made by a US court requiring the US Client to instruct the overseas Trustee to instruct the LLC to distribute the assets will not be enforced in the Isle of Man. The Members of the LLC must resolve unanimously to make a distribution (assuming that the Operating Agreement actually permits distributions (see above)), and the two 'Offshore' Members do not so resolve.

The parties attacking the US Client can either take the action to the Isle of Man courts, and endeavour to look through the trust and then obtain a charging order over the US Client's beneficial Interest, or they can ask the US Court to order the US Client to revoke the Trust, and then by resignation force the liquidation of the LLC.

A very determined judgment creditor might find his way into the Isle of Man court. Let us assume that he does obtain a charging order on the interest of the US member, and seeks to become a member in place of the bankrupt US member. However, the two *Offshore Members* do not approve of any transfer or assignment of the interest, and, in consequence, the creditor cannot become a member, or participate in the management. Such a creditor will only be entitled to receive such distributions as the trustee for the original US client would otherwise have been entitled to. Since the two *Offshore Members* will not agree to any distributions, no distributions can be made.

This means that no transferee can force a distribution. He can only wait until the members unanimously decide to make a distribution. This could be never.

For Tax purposes, however, the creditor/transferee is now entitled to any distributions should they eventually be made, and is thus taxable on the taxable events in the LLC in place of the bankrupt US client. He thus pays tax on profits and gains that are never distributed to him.

Assume now that our creditor backs off the Isle of Man Court approach. He then applies to the US Court for an order ordering the US Member to revoke the trust and by causing the retiral of a member, thereby force a liquidation of the LLC.

However, the two *Offshore Members* resolve to continue the LLC, and to buy out the retiring Member's interests. In accordance with the Agreement (see above), the interests are valued, and a Promissory Note for a 15 year period with interest at 1% is issued to the retiring Member. He passes this to the Creditors.

The Creditors, however, still do not have their hands on the real assets. They may have to wait for fifteen years before the assets materialise. Provided that the LLC always pays the 1% interest, and does not become insolvent, there is nothing the creditor can do, except wait. American Attorneys working on a contingency fee basis will have to wait too.

In the meantime, the LLC will conduct its affairs as its two remaining members determine, in consultation with their new Manager (who will have been appointed prior to the action against the US client and who will be the former US member or his nominee), who will have a generous contract, providing a handsome salary and life assurance/pension benefits, together with a generous severance compensation in the event that the LLC goes into liquidation or that he is obliged to assign the Promissory Note to other parties.

If the LLC has been established fraudulently, with intent to defraud, then clearly any court will order the dissolution of the LLC. But, equally, a Trust established in such circumstances would be voided. If, however, there is no fraudulent act, the LLC must be secure.

Is then the Asset Protection Trust dead? Certainly not. Alaska and Delaware have both recently legislated to provide on-shore Asset Protection Trusts. But I believe that the advantages of the offshore Asset Protection LLC over the offshore Asset

Protection Trust are now so pronounced that it is difficult to see why anyone, who is aware of the options, would choose the offshore Trust.

The King is dead, Long live the King!