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SYMPOSIUM: THE RISE OF THE INTERNATIONAL TRUST

Preface

On February 26-27, 1999, Vanderbilt University Law School and the student-edited Vanderbilt Journal of Transnational Law hosted a symposium entitled "The International Trust." The articles appearing in this issue and the next issue of the Journal are the product of that symposium. The Symposium, as well as this and the next issue of the Journal, represent an attempt to give serious consideration to a topic that to date has received relatively little serious examination.

The international trust, the subject of the Symposium, is experiencing an extraordinary reception worldwide. It is being utilized by individuals from countries with legal cultures that traditionally have not known this form of ownership. In fact, there is no formal legal construct known as the "international trust." Rather, the term as used in the Symposium and as used herein, is intended as an organizing principle to explore the various implications of trusts with international or transborder linkages. The focus is on private trusts, those utilized to manage the wealth of individuals and their families, although much of the discussion pertains as well to trusts used for business, commercial, and broad-based mutual and pension funds.

There is a great similarity between the generative conditions behind international trusts today and the conditions that gave rise to the trust in the first instance. Used as a vehicle for bypassing restrictions on clerical ownership of property in England, the trust soon evolved into an essential and commonplace means both for wealth management and its disposition within a family. The trust's tasks are both of a horizontal and vertical nature. The trust permits private regulation by the settlor and finite differentiation among

beneficiaries at a particular generational level. It also permits precise, private control over the administration of wealth and its disposition among successive generations across time. The settlor can be assured that the plan will be effectuated due to the high duties imposed on the trustee, who serves as a fiduciary. This same private managerial and distributive control system that has traditionally characterized the trust remains much in demand. The international dimension, however, is increasingly taking center stage, and actually effecting an evolution in the trust persona, because of several crucial factors:

1. Increased mobility of capital

Advances in technology have now eliminated delays in the deployment and redeployment of investment capital worldwide. Technology has also afforded access to immediate information worldwide regarding economic and political conditions. These developments have substantially reduced risk in connection with long-distance capital deployment and have enhanced the ability of the investor to seek globally the most efficient market for his capital.

In addition to the rise of global portfolios, the barriers that previously existed in terms of currency exchange and capital export controls have largely fallen. Thus, far fewer restrictions limit the investor's ability to take advantage of promising investments in other parts of the world.

The potential for the free outflow of capital to the most competitive markets has also exercised an impact in fostering the deregulation of imported capital. Previous concerns regarding foreign economic imperialism have become less defensible in view of the intense competition for capital. Countries must now compete to retain capital as well as to attract new capital.

In this new environment, a settlor in Europe or South America can transfer assets electronically to a trustee in the Cayman Islands. The trustee can obtain real-time information from New York and Hong Kong. On the basis of that information, the trustee can proceed to make investment allocation decisions and then effect these decisions in an instant.

2. The rise of the geographically extended family

The collapse worldwide of investment barriers and the correlative development of technologies that facilitate universal investment strategies also exert pressure in favor of the worldwide free flow of labor. This is especially true among the highly educated and those proficient in much-needed technical skills. Immigration and visa restrictions have, of necessity, become less rigid. High-level executives spend considerable time in other jurisdictions and develop enduring ties. Concomitantly,

traditional national, racial, religious, and social constraints regarding marriage and family formation are falling. Persons with ties to and family capital in more than one country join together and intertwine their economic interests. Members of families seek out the best educational and employment opportunities, wherever they may be located. This worldwide education and labor market tends both to create multinational families and to spread out families, not unlike the great mobility experienced within the United States' "common market" in the post-World War II period.

In short, wealth now has to be managed and will be ultimately distributed in ways that do not respect artificial political and territorial barriers. Family beneficiaries may live under multiplicitous legal and taxation systems that diverge from one another. These systems may also diverge dramatically from the system under which the original owner lives or lived. They may also be unlike that of the jurisdiction exercising authority over the underlying assets.

The territorial incohesion of families and assets can also be explained in part by the vast, involuntary movements of millions of refugees during this century. Inevitably, as many of these persons and their successors have flourished economically in host countries, they have also renewed ties with persons who have remained behind. Eventually, capital may be invested there, using the competitive advantage in terms of information and contacts that these refugees have.

3. The rise of a universalist culture

The previously discussed developments are also facilitating the emergence of a cultural outlook that previously typified only a minute fraction of the population with vast resources. This universalist outlook regards capital as country-neutral and deems territorial borders archaic barriers to the maximization of individual and family wealth. With capital and family dispersed worldwide, allegiance to any one jurisdiction grows increasingly tenuous. Domestic government is essentially a problem of public choice, an additional cost of doing business.

4. The rise of the offshore jurisdiction

The political pursuit of self-determination and human rights ended colonialism, which contributed to the rise of a slew of mini-states. A preeminent principle of the post-World War II international legal order has been respect for national sovereignty, no matter how artificial the particular sovereign state. These states belong to the United Nations and other international organizations. They issue passports, enact internal laws, control their borders, and fly their own flags.

Beyond the formal façade of sovereignty and the enforcement of a stable system of autonomous nation-states, there thrives an unregulated bazaar for free capital. Mini-states, with little else to sustain them, function as filters in the worldwide free flow of capital. They are way-stations in the passage of capital from one sovereign country to its redeployment in another sovereign's territory.

These mini-state intermediaries typically are island nations. They lie directly offshore the country which is the destination for freed capital. Alternatively, they can be found offshore the jurisdiction from which capital has been freed. Once offshore, the capital becomes essentially untraceable by the source country for purposes of taxation and other forms of regulation. It is then invested in the import market, but at favorable rates and deregulation. The Caribbean island nations and Bermuda perform this function for the United States. The Channel Islands perform the same function for the United Kingdom and Europe.

The offshore jurisdictions, despite incessant onshore criticism of them, could not thrive without tacit onshore tolerance, if not active support. An example is the United States. A major capital-importing country, it has permitted offshore jurisdictions to draw in capital from other high tax and regulatory states in Europe and Asia. It has historically afforded massive tax benefits for foreign investment in an undeniable effort to lure the capital. Since all residents and citizens of the United States are taxed on worldwide income, the offshore platform permits investment in the country without experiencing the full brunt of federal taxation and with the benefit of certain exclusions afforded to foreign persons.

Offshore jurisdictions, however, are agnostic. They absorb capital as well from the same countries in which capital is invested. This phenomenon is quite evident in the case of the United States. For example, in response to high-priced tort recoveries, offshore jurisdictions have marketed trust-related legal structures that purportedly afford asset protection from onshore litigants.

5. Enhanced national and state regulatory regimes

The same technology that permits rapid worldwide capital flows also permits the establishment of more efficient and effective domestic regulatory regimes. Democratic regimes in industrialized societies are unpredictable in terms of the precise levels of taxation and other impositions over time, but, even at their best, demand substantial amounts for redistributive purposes. Other state-sanctioned private legal obligations, such as postmortem spousal and child protection regimes, are also a standard feature of such systems. Indirect transfers of wealth

through a system of largely unrestrained jury-based tort awards further expose individual capital to significant costs and risks. This regime of redistribution and regulation spurs an inevitable and intensifying clash between the sovereign and its benefactors on the one hand, and the more limited number of high net worth individuals seeking to preserve and even enhance returns on their capital on the other hand. Increasingly, the latter individuals seek to cut costs through the international trust administered from a jurisdiction with a nonredistributive and nonregulatory environment.

6. The clash of legal regimes

Whenever capital is invested elsewhere, there is likely to be a clash of legal regimes. The legal regime of the wealth-owner may well differ from that of the situs of capital investment. The ultimate beneficiaries of the wealth-owner's largesse, if not himself, may be affiliated with and subject to still other legal and taxation regimes. The perceived need for a single, predictable governing law is considerable, especially if significant external costs are to be avoided.

The clash of legal regimes is not exclusively between countries with completely alien legal traditions. In many instances, similar regimes with common roots, like that of the United States and the Commonwealth countries, diverge as well, although admittedly not to as extreme a degree. Thus, to the extent the administration of wealth can be brought under a single system of rules governing the trust, it is likely to be strongly preferred. The international trust holds out this promise by centralizing the determination of rights and duties at the situs of trust administration and through a designated governing law.

The six factors that have been considered above explain the environment in which the "international trust" flourishes. They also help explain its growth and evolution from a purely domestic instrument for capital management and distribution. As noted, the trust permits centralized management of worldwide investments from one geographic locale. Modern technologies assure that administration from that location does not result in a palpable competitive disadvantage.

The preferred geographic locale for centralized international trust administration is one that affords a reliable, stable tax- and regulatory-free regime. The trustee is offshore and does not reside at the source. Efforts by the source jurisdiction to obtain information to determine whether the transferor still retains substantial economic control over the assets are likely to prove fruitless. The offshore international trust haven typically enforces severe confidentiality rules with respect to the trust.

Moreover, the investment capital may not be owned by the trust itself, but rather by a corporation or other entity organized in still another jurisdiction but controlled directly or through a chain of ownership by the trustee of the international trust.

In addition to the residence of the trustee abroad, the original wealth-holder is not likely to remain in his country of citizenship. In many cases, by shifting residence, he avoids its taxation and regulatory regimes. This does not mean he will reside where the trust is administered. The offshore jurisdiction is not likely to encourage an influx of such persons, destabilizing its own sensitive political and social structures. Capital, not people, is being attracted.

The commonplace result is one of the settlor residing in one country, the trustee administering the trust in a second, and the beneficiaries residing in a third and fourth, with the underlying assets scattered all over the world. The situs of the trust is in a jurisdiction in which the rule of law has long prevailed and where political stability is guaranteed by proximity to a dominant capital-importing country like the United States. The fiduciary principles that lie at the heart of trust law afford the further guarantee necessary in light of the often substantial physical distance between interested parties and assets. As a fiduciary, the trustee faces considerable liability for mismanagement. Indeed, improper or negligent administration jeopardizes the very status of the offshore jurisdiction and the wealth it earns as a capital flow way-station. In an intensely competitive market for the capital, improper management cannot long be tolerated. Loss of status is especially threatening, since it could dry up the predominant source of white-collar employment that assures local, social and political tranquility in the offshore haven.

The intense competition for capital among offshore jurisdictions creates a buyer's market. A trust legislation free-for-all has developed in which there is a race-to-the-bottom, from one perspective, or a maximization of trust corpus protections, from another perspective. Thus, legislation shields the trust's assets from post-transfer onshore creditors. Claims of spouses, children, and other family members back home to a portion of the wealth in trust are not accorded recognition, even assuming the wealth can be located.

The issues concerning the "international trust," however, are not simply "offshore" issues. In many developed countries that have not recognized the trust as a distinctive form of ownership and management of property, the trust is, nevertheless, making inroads. Even when constructed on a common law offshore platform, there may be a deployment of its capital in a civil law, nontrust environment. If an issue arises as to local control, taxation, regulation, or rights, how is the trust to be

characterized? Increasingly, nontrust jurisdictions, as capital importers, are realizing the need to come to terms with the trust, either by recognizing it, and/or by actually incorporating it within its own legal system. They are also having to develop a regime of taxation by analogy to the taxation of comparable domestic institutions.

Why has the trust assumed the role described, rather than that role being assumed by the corporation, which has been far more widely accepted? There are a number of reasons for this. Perhaps the principal one is that someone must own the equity of the corporate entity. It cannot be the original owner, or else he will face the same problems that led him to look abroad in the first place. Ultimately, a legal person, distinct from the original owner and also from the ultimate beneficiaries, is necessary.

With the foregoing background, the significance of the articles appearing in this issue and the following issue of the *Journal* should be apparent. The first topic addressed in the present issue deals with the divergencies in English and American trust law. As noted, the trust is a common law concept with an overlay of statutory enactments. However, the English and American sources of this law have been far from consistent. The lack of harmony is not merely a matter of academic interest. The international trust, as a universal operating system, requires a single language for maximum efficiency and broad acceptance.

The articles by Professors Edward C. Halbach, Jr. and David Hayton are essential in this regard. Their dialogue not only illuminates areas of disharmony, but also reveals the likely evolution of these two branches of trust law, including the prospects for harmonization.

With the increasing prominence of the international trust, the offshore jurisdictions have become a third source for trust law internationally. They have shown great creativity and responsiveness to the needs of owners of capital in shaping trust law legislatively. Still, these jurisdictions are heavily influenced by the evolution of the law in the United States and the expectations of capital importers and re-importers there. On the other hand, the offshore jurisdictions are also heavily steeped in the process and substance of English law. Thus, the differences in U.S. and English trust law create real tensions with respect to the effective administration of international trusts.

The second set of articles deals with U.S. taxation of foreign trusts. An elaborate structure for U.S. taxation of such trusts was enacted in 1996 and has been amplified upon by extensive treasury regulations promulgated on February 2, 1999. The original purpose of foreign trust tax legislation was to assure that U.S. taxpayers did not reduce their tax liability by accumulating income in an offshore trust, thereby deferring income taxation

until its repatriation. The more recent law is especially designed to discourage remaining opportunities, such as the use of international trusts by nonresident aliens before emigrating to the United States or to benefit their family members in the United States.

On the other hand, the new legislation and treasury regulations may have actually opened up certain opportunities for foreign trusts that previously did not exist. Specifically, in seeking to define objectively what is a "foreign trust," the new legislation draws a bright line that permits structuring trusts so that they fall on the preferred side of that line.

With considerable acuity, Carlyn S. McCaffrey and Elyse G. Kirschner explore the maze created by the new Code and treasury regulation provisions. In addition to affording a fascinating roadmap through the maze, their article, *Learning to Live with the New Foreign Nongrantor Trust Rules*, demonstrates the difficulty of addressing legislatively the multitude of trust arrangements that can be devised in the struggle between grantors worldwide and the U.S. tax authorities. The article also exposes the inevitable generation of unintended consequences, including new loopholes, that are a product of such legislation.

In a second tax article, *Respect for "Form" as "Substance" in U.S. Taxation of International Trusts*, Donald D. Kozusko and Stephen K. Vetter address the regulatory conundrum posed by enforcing hard-and-fast rules in the international trust context. They argue that, in the case of transfer taxation and trust income taxation, substance has often taken a back seat to form. Indeed, form is substance. This reality effects the choices that are routinely made between the utilization of one form of ownership over another. The Code very clearly details different tax consequences, depending on the choice of form made.

In the case of international trusts, under the new tax regime, the jury is still out as to whether form will be submerged by broad doctrines of economic substance and step transactions, or whether form will still prove to be the substance of the law, more generally characterizing the U.S. taxation regime relating to foreign trusts. Ironically, as Kozusko and Vetter point out, the misplaced rigor of the Code's entity attribution rules may actually subvert the substantive goals served by formalism.

The last topic explored in this issue of the Journal is asset protection, especially in conjunction with the international trust. There are articles by leading proponents, including Gideon Rothschild, Daniel S. Rubin, and Jonathan G. Blattmachr, as well as by a leading critic, Eric Henzy, who successfully challenged an asset protection structure in the recent decision of *In re Brooks*. In addition, the transcript of a spirited Roundtable discussion reveals the views of Barry S. Engel, one of the

originators of asset protection strategies in response to the tort liability "crisis." As part of this Roundtable and in a separate article, David Aronofsky elucidates the efforts of Montana to become a bank secrecy center.

Properly understood, the asset protection debate is about the use by a high net worth individual of the international trust in an offshore jurisdiction to counterbalance the risk of unbridled tort liability in the United States. A particularly striking aspect of the Symposium's exploration of this issue is its consideration of the efforts of Alaska and several other jurisdictions within the United States to attract some of the capital administered offshore. An Alaskan asset protection trust seeks to afford the protections of an international trust but without the dangers perceived in placing capital in "exotic" jurisdictions offshore. However, the viability of the effort by Alaska and several other states may be hampered by certain constitutional constraints, most notably the Full Faith and Credit clause as applied within the United States. A Vanderbilt student and member of the Journal, Amy Lynn Wagenfeld, addresses and critiques this development.

In the next issue of the Journal, the in-depth consideration of the international trust will continue. The actual product emerging offshore and the offshore "viewpoint" as to salient issues will be examined in detail. Then, a number of articles will review the efforts to gain recognition and incorporation of the trust into the law of European civil law regimes, with particular emphasis on Italy and the Netherlands. Recognition and/or incorporation are crucial for the universal acceptance of the international trust as a worldwide wealth management and disposition tool. They are also crucial if capital managed via international trusts is to be deployed more efficiently and predictably in the many civil law jurisdictions worldwide.

The next issue will also consider ethical issues, money laundering, and similar enforcement concerns. The international trust has the potential to be subverted for criminal purposes. On the other hand, this may be in certain cases a matter of perspective. At least when the effort is one of minimization or elimination of taxation and restrictions on testamentary freedom of legitimately acquired wealth, other countries, especially capital importers, have not been especially keen on enforcement efforts. However, a combined, international effort may be altering this, as developed countries fear the aggregate loss of substantial tax revenues and control over development capital that is being exported.

Finally, the next issue of the Journal will explore comparable institutions in very different legal systems. As a specific basis for comparison, the *wakf* of Islamic law will be considered. To the extent it is genuinely similar to the trust, this identity may afford

evidence of a more pervasive impulse to utilize certain legal structures with generic attributes by individuals and families in an effort to avoid state regulation of wealth. On the other hand, the failure of the Islamic *wakf* to maintain significance as a private wealth management device over time may help isolate those peculiar attributes of the trust that have catapulted it to its current position as the preeminent legal construct for the management and disposition of individual and family wealth internationally.

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TOPIC I

Divergent Trust and Fiduciary Standards in the Common Law Countries

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