



Newsletter



Offshore Trusts

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Offshore Trusts

Offshore trusts are a powerful tool in the estate and tax planning world, but are commonly misunderstood and misapplied. This article will explore the offshore trust to reveal that, when used correctly, the offshore trust is an extraordinary planning tool.

Definitions

A trust is an entity that owns and manages assets. A trust is operated by a trustee to benefit those we care about (the beneficiaries). There are many variants of trusts, each designed to accomplish particular goals and each with assorted characteristics that impact control, taxation, protection, disposition, etc. In most cases, there is a tradeoff between control and protection.

An offshore trust is a trust that is established in a jurisdiction outside of the United States. Laws vary by state and vary by country. The concept of selecting the most advantageous location is common, for example, the majority of new companies formed in the U.S. are domiciled in Delaware due to its favorable laws. Most offshore trusts, and the trust this article will concentrate on, is the asset protection trust. The statutes in most U.S. states provide that one can create a trust that will protect the assets it holds (meaning a potential creditor cannot reach the assets), however, the client may not retain significant controls over, or benefit from, the trust and still maintain asset insulation. If one is both a trustee and beneficiary simultaneously, a U.S. court could require you as trustee to distribute to yourself as beneficiary trust assets to satisfy your creditors. If this were not the case, in an extreme, any U.S. person could create a trust, contribute all his assets into it, control the assets but avoid liabilities. Offshore jurisdictions developed the initial form of the asset protection trust in the early 1980s and provided a structure in which the client could retain benefit of the trust (as a discretionary beneficiary) while simultaneously protecting assets. (In the late nineties several U.S. states mimicked offshore asset protection trusts with similar statutes of their own, and U.S.

asset protection trusts can be very useful, however, there is no significant case history).

Goals and Benefits

Before understanding the how of an offshore trust, we should explore the why. The primary advantages of an offshore trust are asset protection and estate planning (tax reduction, gifting vehicle, and probate avoidance). Asset protection is a subspecialty of estate planning that focuses on how to insulate assets from predatory claims. Many lawsuits are based on what a plaintiff believes they can collect rather than actual wrongdoing. As theories of liability continually expand, judgments are becoming more commonplace even when a defendant's connection to a case is tenuous.

Asset protection is not a specific technique but rather the purposeful structuring of assets to limit liability exposure, make assets difficult to attach to, and segregate risk. Many times techniques are used in concert to enhance protection and exploit and combine benefits. A creditor may place a lien on assets owned personally, jointly, partnership, corporate, etc. but the statutes governing preferred entities preclude a lien on entity assets for claims against the owner. Thus, achieving asset protection usually revolves around using entities that have insulative characteristics, i.e. limited liability companies, limited partnerships, some trusts, and then separating assets more likely to generate a liability. Segregation of risk involves separating assets that may generate a liability into distinct containers to preclude an asset being targeted by a litigation from impacting other assets. This is often seen in practice as a separate LLC for each riskier type asset (i.e. businesses, real estate, recreational vehicles).

The offshore asset protection trusts are considered the strongest asset protection device available. The statutes in preferred jurisdictions preclude a creditor of a beneficiary from being able to attach or benefit from any of the trust assets and are pro-asset

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owner. Touching on the key aspects of the statutes:

(a) *Level of Proof.* U.S. law typically requires proof by a “preponderance” of the evidence, essentially a 51% standard, whereas preferred offshore jurisdictions require proof beyond all reasonable doubt, effectively a 95% proof standard (which the U.S. only applies for criminal matters).

(b) *Statute of Limitations.* U.S. law typically has a four year time period in which to bring a claim, whereas preferred jurisdictions often have a one year statute. Thus a creditor must sue in the U.S., endure all appeals, and start a judgment enforcement action all within one year.

(c) *Representation.* While attorneys in the U.S. may be paid by contingency, no other country operates on that system and most attorneys would require payment in advance. The plaintiff's U.S. attorney, not being licensed in the preferred jurisdiction (no licensing for non full time residents), would not be permitted to participate.

(d) *Case Law.* The best of statutes are theoretical until a court actually applies them. The leading jurisdiction is the Cook Islands and ruled on the Andersen case in 1999, and while the facts were not ideal (as the Anderson's did act dishonorably after the trust was created) the courts confirmed that they would apply the trust law as intended.

Similarly, estate planning is not a specific technique or product but instead is a program of tools to reduce death taxes and eventually transfer assets to the younger generations in an efficient manner. When addressing estate planning most aim to reduce eventual estate taxes, but often would like to retain control and access to funds if needed. Most trusts that aim for estate tax reduction require a completed gift, in which the client must cede control and/or

access to funds. An offshore trust, on the other hand, can have the client as a beneficiary and the client can often retain much control (by maintaining the management rights of an LLC and the trust owns the non-voting interests of the LLC). Further, the trust can work hand in hand with gifting. Rather than protect and gift just the lifetime exemption (\$1 million) the trust can be designed to have two halves – one side to be protected and includable in the estate and the other side to also be protected but estate tax free. This permits one to protect all assets and selectively gift the assets most likely to appreciate to maximize gifting ability while using the same vehicle and protecting the entire nest egg.

Jurisdiction

Several countries, in a Delaware type manner, have established trust laws specifically to attract trust business to their locale. A trust concentration allows the country to generate growth of professional and financial jobs and increase revenue to the region. Many of the locations that most envision when thinking of offshore trusts – Bermuda, Bahamas, Cayman Islands – are not leading jurisdictions, rather just close geographically. Most of the Caribbean locations have laws that were not drafted with much detail, leaving too many substantive issues unknown and untested, and further, are subject to U.S. pressure (usually restrictions on tourism to encourage cooperation or modification of the laws). Jurisdictions that are desirable possess detailed, sophisticated statutes, case history showing the courts enforce the statutes, flexibility in construction of the trust, flexibility to structure in compliance with U.S. tax rules, and modern communications ability. There are several jurisdictions that have become desirable, namely Cook Islands, Nevis, Jersey, Isle of Man, and Guernsey.

To benefit from a preferred jurisdiction, a trust can be formed there. However, trust assets usually remain in their existing location; of course real estate does not move, investment accounts stay with the current

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manager, business operations remain. Assets themselves do not move, merely ownership and titling documents do. The trust is required to maintain some connection to the trust domicile, and this is usually accomplished with a local trustee (please note this role is usually defined as an “administrative trustee” who has no voting control but instead is responsible for local records and filings and the “independent trustee” is a person of the clients election).

Compliance

As with any planning tool or technique, there are rules and compliance to follow. Offshore trusts have an initial and an annual disclosure filing (form 3520) with the IRS. There is no additional tax due but failure to file issues may generate expensive penalties thus good attention to detail is required. Thus coordination with the client’s accountant is helpful.

Some banks and other financial institutions have trouble understanding offshore trusts or fear the due diligence for anti-money laundering or know your client regulations. Typically though, an underlying LLC owns the asset or bank/investment account thus the trust doesn’t come into play directly, which

mitigates the diligence.

Income Taxes

Offshore trusts are almost always designed to be grantor trusts (as the client keeps some strings or connections to the trust) making it income tax neutral: all income and deductions flow from the trust to the client’s individual income tax return. Though a common thought, offshore trusts do not save any income taxes as the US is a global taxing jurisdiction and, regardless of where an asset is held, if the client is a US citizen they are intended to pay tax on global income. As the trust benefits future generations, there is flexibility for younger generations to spread out tax burden among the lowest income earners or to have the trust absorb the tax.

Suitability

Offshore trusts are best suited to families who have significant risk exposure, often generated by real estate holdings, operating businesses, recreational vehicles, employees, and the like. The author has used them in planning for families that have businesses that are open to the public (i.e. malls,

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restaurants), real estate, particularly rental real estate, businesses that produce a product with injury potential, and so on. It is also preferred by families doing multi-generational and dynasty planning as sophisticated offshore trusts coordinate protection and tax relief in perpetuity thus significant planning does not have to be recreated at each generational level. There is no specific net worth level in which offshore asset protection trusts are absolutely indicated or counter-indicated – it is applied by balancing risk, comfort, and family structure.

Penetrating a Trust

Asset protection is effective against future claims, and can be penetrated by a creditor whose claim existed before the protection planning occurred and if the client knew, or reasonably should have known, of the claim. Transfers of assets in protected vehicles with a present claim are subject to a claim of fraudulent conveyance – essentially a request to set aside the transfers. In most states and countries a fraudulent conveyance claim can be brought within a four year statute of limitations. Offshore jurisdictions use a one year statute, a virtually impossible standard.

Offshore asset protection trusts are the most powerful protection but are also subject to fraudulent conveyance claims. Common sense applies to the definition of a known claim – if the client is aware of a lawsuit, regardless of a court filing. A claim one reasonably should have known about is fact specific, but an example may help; an accident occurs on Monday and client establishes protection plans on Tuesday.

Protection With an Existing Problem

While fraudulent conveyance is known issue, it is possible to perform some protection even if a claim exists. The touchstone of fraud is reasonableness, thus planning can insulate some assets as long as a reasonable amount remains exposed to satisfy the current claim. For instance, a client has a net worth

of \$100 and there is a pending lawsuit for \$20, we can insulate \$75 and leave \$25 exposed. Issues arise when families attempt to insulate all assets when there is a pending claim.

Case Study

To apply an offshore protection trust to a real, redacted case which author Chodos performed the planning: The Johnson family enjoyed a net worth of approximately \$100 million, consisting of an operating business, real estate, investments, and art. They have four adult children and several grandchildren, one child and one grandchild are part of the family business. While they have enjoyed good success, the Johnsons were risk sensitive, and were concerned about the potential for a business based lawsuit (from employees), risk of divorce at the children's generation, and managing net worth to encourage children and grandchildren to achieve but not bestow so much that the younger generations lose touch with work ethic. Several limited liability companies (LLCs) were created, one for each parcel of real estate, one for the art, one for investments, and one for business inventory, with the parents retaining the sole vote of each LLC and having the non-voting portions owned by an asset protection trust. As the senior Johnsons were the managers of the LLCs, they made all decisions regarding profit, salary, operations, etc. A nephew of the Johnsons served as the independent trustee of the trust, but had minimal role as the trust holds non-voting ownership of LLCs. For the assets most likely to appreciate (a new spinoff business venture) was gifted but within the trust – to the non-estate taxable side. The plan achieved a reduction in death taxes of eight figures, shielded the vast majority of the family assets from divorce, business claims, and other potential predatory attacks. The management was vested in the senior family with a transition program to slowly groom the children to assume control once the senior generation was gone.

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Conclusion

Offshore assets protection trusts are a powerful tool in the planning arsenal that can provide unparalleled asset protection, yet still allow family control while coordinating with tax minimization and multi-generational planning.

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