

**Offshore Trusts as Tools and Strategies for Estates of U.S. Residents:  
Comparing Offshore to Onshore**

Offshore, or foreign, trusts are clouded in a bit of mystery similar to some of their remote jurisdictions. The Hague Convention on the Recognition of Trusts permits the settlor to choose the location and the applicable laws where he or she wishes to place the assets, including in offshore trust accounts.<sup>1</sup> Yet, the United States Internal Revenue Service (IRS) estimates that nearly \$4.4 billion U.S. dollars are located in offshore accounts.<sup>2</sup> Typically, when the average person hears “offshore” the immediate reactions are tax evasion or money laundering. While those activities certainly do happen – and there is ample case law to reaffirm any doubt – there are legitimate reasons that an estate planner should not automatically ignore offshore trusts as a viable planning mechanism. An estate planner already considers the unique needs of his or her client, and it is possible that the offshore trust would meet those needs better than a domestic trust. In recent years, *onshore* jurisdictions have conferred some of the same benefits, adding to the complexity. Experts in offshore trusts caution that such trusts are just one estate and gift planning tool and should be used with the requisite thoughtfulness.<sup>3</sup> The U.S. Senate even commissioned the Office of Homeland Security to review abusive tax shelters, in which it included offshore trusts.<sup>4</sup>

**I. Offshore Trusts in Estate Planning**

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<sup>1</sup> Dr. Rose-Marie B. Antoine, *Caribbean Legal Affairs: Waiting to Exhale: Commonwealth Caribbean Law and Legal Systems*, 29 *Nova L. Rev.* 141, 162-163 (2005).

<sup>2</sup> Elizabeth Ody, *Tax Hunt Pushes Global Wealthy into Offshore Trusts for Children in U.S.*, Bloomberg, March 6, 2012, available at [www.bloomberg.com/news/2012-03-06/tat-hunt-pushes-global-wealthy-into-offshore-trusts-for-children-in-u-s-.html](http://www.bloomberg.com/news/2012-03-06/tat-hunt-pushes-global-wealthy-into-offshore-trusts-for-children-in-u-s-.html), last accessed March 28, 2012.

<sup>3</sup> Duncan E. Osborne, *The 27<sup>th</sup> Annual Phillip E. Heckerling Institute on Estate Planning, Chapter 17: New Age Estate Planning: Offshore Trusts*, 27-17 Univ. of Miami Law Center on Est. Planning 1707.

<sup>4</sup> Office of Homeland Security, *Tax Haven Abuses: The Enablers, the Tool and Secrecy*, reprinted at *Tax Notes Today*, 2006 TNT 147-18 (2006).

In general, a primary reason clients tend to use offshore trusts is for asset protection. The motivations of the individual may vary, but the underlying premise is that they want to have greater protection from creditors. This poses a direct conflict with the U.S. fraudulent transfer rules. Every U.S. state has some form of fraudulent transfer law prohibiting the transfer of “assets in order to hinder, delay, or defraud creditors” stemming back to the Statute of Elizabeth.<sup>5</sup> Not every foreign trust grantor has the requisite intent to defraud his creditors somehow; however, U.S. courts tend to apply a rebuttable presumption in the favor of the creditor, placing the onus on the grantor or beneficiary of an offshore trust to prove the legitimacy of the trust.<sup>6</sup>

For estate planning purposes, there are other proper reasons for offshore trusts in estate planning. The client may have a profit incentive, since the U.S. Securities and Exchange Commission regulations limit the access of U.S. investors in “certain foreign mutual funds, hedge funds, and other investment vehicles.”<sup>7</sup> The client may have a desire for financial privacy from any of “the IRS, creditors, competitors, ex-spouses, and others with an interest in [his] wealth.”<sup>8</sup> The client may wish to minimize his tax consequences – without evading taxes – and this is entirely possible depending upon the jurisdiction’s laws and reciprocal tax treaties with the U.S.<sup>9</sup> Specifically, by structuring a foreign non-grantor trust, generation-skipping transfers may be tax exempt.<sup>10</sup> The client may have personal reasons, such as moving to a different country

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<sup>5</sup> Richard C. Ausness, *The Offshore Protection Trust: A Prudent Financial Planning Device or the Last Refuge of a Scoundrel*, 45 Duq. L. Rev 147, 158 (2007).

<sup>6</sup> *Id.*

<sup>7</sup> Duncan E. Osborne, Asset Protection: Trust Planning, SS010 ALI-ABA 2069, 2130 (2010).

<sup>8</sup> B. Chad Bungard, Offshore Banking in the British Dependencies, 9 Touro Int’l Rev. 141, 144 (2001).

<sup>9</sup> *Id.* and Duncan E. Osborne, Asset Protection: Trust Planning, SS010 ALI-ABA at 2132.

<sup>10</sup> Duncan E. Osborne, Asset Protection: Trust Planning, SS010 ALI-ABA at 2132.

and changing domicile or citizenship.<sup>11</sup> In one example, the client moved from Switzerland to the U.S., and in doing so triggered a tax liability.<sup>12</sup> By stopping off in Ireland, he was able to place certain investment assets into trust and establish a higher basis.<sup>13</sup> Other personal reasons may include everything from asset protection for heirs, premarital planning, to avoiding forced dispositions.<sup>14</sup>

In order to rebut the presumption that essentially every offshore trust is participating in illegal activity, the attorney and client can establish an early legitimacy of the trust by identifying the client's motives. The attorney should review the client's financial situation thoroughly to determine if there is a threat of a fraudulent transfer.<sup>15</sup> Historically, fraudulent transfers look for

“badges of fraud ... : (1) understatement of income, (2) maintenance of inadequate records; (3) failure to file tax returns; (4) implausible or inconsistent explanations of behavior; (5) concealment of income or assets; (6) failure to cooperate with tax authorities; (7) engaging in illegal activities; (8) dealing in cash; (9) failure to make estimated tax payments; and (10) filing false documents.”<sup>16</sup>

By leaving sufficient funds to cover onshore creditors, the legitimacy can be established. Though not directly addressed, there is probably a continuing need to update as both additional assets are transferred to offshore trusts and as additional credit is leveraged.

#### **A. Legal Benefits**

The legal benefits of offshore trusts will vary based upon the specific jurisdiction that has legal oversight. Roughly, a dozen international jurisdictions have made themselves very

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<sup>11</sup> *Id.*

<sup>12</sup> Elizabeth Ody, *Tax Hunt Pushes Global Wealthy into Offshore Trusts for Children in U.S.*, Bloomberg, March 6, 2012, available at [www.bloomberg.com/news/2012-03-06/tat-hunt-pushes-global-wealthy-into-offshore-trusts-for-children-in-u-s-.html](http://www.bloomberg.com/news/2012-03-06/tat-hunt-pushes-global-wealthy-into-offshore-trusts-for-children-in-u-s-.html), last accessed March 28, 2012.

<sup>13</sup> *Id.*

<sup>14</sup> Duncan E. Osborne, *Asset Protection: Trust Planning*, SS010 ALI-ABA at 2132.

<sup>15</sup> *Id.* at 2130.

<sup>16</sup> *Richardson v. Commissioner of the Internal Revenue Service*, T.C. Memo 2006-69 at 65-66; 2006 Tax Ct. Memo LEXIS 71, 91 T.C.M. (CCH) 981 (2006).

accessible and amenable to hosting U.S. assets and titles within their borders. For the most part, they provide common features, listed in no particular order:

1. Nonrecognition of U.S. Judgments, forcing a de novo case within that territory;
2. Short Statute of Limitations;
3. Banking secrecy laws;
4. Heightened burdens of proof;
5. Certainty of law;
6. Circumventing succession and heirship laws; and
7. Greater control over assets.<sup>17</sup>

Under the U.S. interpretation of international law, when the laws of the U.S. conflict with international law, the U.S. domestic law is recognized as preemptory, so the laws of other nations may not be asserted within the U.S. jurisdiction.<sup>18</sup> Similarly, under the doctrine of comity, a sovereign nation's judgment will usually be recognized within the U.S.<sup>19</sup> Often, this is not reciprocal, and the U.S. may not force application of its law or expatriate funds. Instead, the sovereign nation is to implement its own laws with respect to the offshore trust.<sup>20</sup> As such, the sovereign nation may not – and usually does not – recognize judgments of U.S. courts. Thus, the contesting party or creditor must physically initiate new litigation in the court system of the sovereign nation. Often these jurisdictions have short a statute of limitations that has tolled prior

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<sup>17</sup> John E. Sullivan, III, Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes with Offshore Trusts, 23 Del. J. Corp. L. 423, 476 (1998); Evan Metaxatos, Comment Thunder in Paradise: The Interplay of Broadening United States Anti-Money-Laundering Legislation and Jurisprudence with the Caribbean Law Governing Offshore Asset Preservation Trusts, 40 U. Miami Inter-Am L.Rev. 169, 174 (2008); and Barry Engel, Comments at Roundtable Discussion at Vanderbilt University School of Law, 32 Vand. J. Transnat'l L. 779, 802 (1999).

<sup>18</sup> David Aronofsky, Comments at Roundtable Discussion at Vanderbilt University School of Law, 32 Vand. J. Transnat'l L. at 779, 800.

<sup>19</sup> Evan Metaxatos, Comment, *Thunder in Paradise: The Interplay of Broadening United States Anti-Money-Laundering Legislation and Jurisprudence with the Caribbean Law Governing Offshore Asset Preservation Trusts*, 40 U. Miami Inter-Am L.Rev. at 177 (2008).

<sup>20</sup> Richard W. Nenno, *Planning and Defending Domestic Asset-Protection Trusts*, ST 022 ALI-ABA 637, 851 (2011).

to their attempt to enforce the U.S. judgment. The secrecy and privacy within the sovereignty's legal framework may appeal to some clients.

The structure of the offshore trust, discussed below, is slightly different and affords certain protections, but the grantor and the beneficiaries are still responsible for all applicable U.S. taxes, since the U.S. taxes on worldwide income and assets. The Sixteenth Amendment provides the authority for the U.S. to tax income, just as the Supreme Court decision in *Brushaber* provides the authority to tax the right to transfer at death.<sup>21</sup> Unlike domestic trusts which are required to recognize the judicial proceedings from other states, the Full Faith and Credit clause of Article IV, Section 1 of the U.S. Constitution does not apply to offshore trusts.<sup>22</sup>

## **B. Legal Detriments**

### **1. Heightened IRS Scrutiny**

Annually, grantors, beneficiaries and some trustees are required to file several IRS forms, discussed below, thus providing self-disclosure of offshore trusts. The IRS has issued a series of amnesty programs to allow trust settlors and beneficiaries to come current on back taxes without penalties. It has also released warnings for taxpayers that while offshore trusts are perfectly viable planning tools, taxpayers need to make sure they are current on income tax, gift tax, and estate taxes.<sup>23</sup> Tax Analysts have advised that by filing the appropriate tax forms – checking yes to “interests or signature authority over accounts in a foreign country” on Form 1040 – one almost certainly opens himself up to an audit.<sup>24</sup> The U.S. has entered in to both multilateral and

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<sup>21</sup> United States of America v. Rhodes, 921 F. Supp. 261, 265 (1996).

<sup>22</sup> Richard G. Bacon and John A. Terrill, II, *Domestic Asset Protection Trusts Work – Should They?* 26 Tax Mgmt. Est., Gifts & Tr. J. 123 (2001).

<sup>23</sup> Tax Analysts of Tax Notes Today, *The IRS' Fight Against Abusive Offshore Trusts*, §671 – Grantors as Owners, Doc 2000-18595, at 2-3.

<sup>24</sup> *Id.*

bilateral treaties with many nations and is applying pressure to Caribbean policy. Yet, certain jurisdictions have stood their ground and not revised legislation.<sup>25</sup>

## 2. Heightened Judicial Scrutiny

Given the notoriety offshore trusts have, many judges apply heightened judicial scrutiny to ensure that the public's interest is protected by the laws of the U.S. A few U.S. states are worth noting for federal estate planning rules, despite their on-point application to federal income tax rules. The general impossibility of performance principle "is that [the client] cannot be held in contempt of court if [he did] not have the power or ability to comply," so long as the client did not create the impossibility.<sup>26</sup> Courts are reasonably sure to follow the governing case law from the federal income tax cases given the breadth of the case law and the impact on public policy. In the now infamous tax evasion case, *Federal Trade Commission (FTC) v. Affordable Media, LLC*,<sup>27</sup> the Andersons orchestrated a Ponzi scheme to bilk clients out of millions that they then placed in a Cook Islands trust.<sup>27</sup> The trust documents provided for a local trustee plus the Andersons, and added a duress clause that would automatically sever the Andersons as trustees if the trust became subject to litigation. When the FTC filed against the company, the Andersons claimed they no longer had control of the funds because they were no longer trustees. The Ninth Circuit ignored the impossibility defense and eventually imprisoned the Andersons for failure to comply with the court's order.<sup>28</sup> The impossibility was of the Andersons own making and was, therefore, not a viable defense. Since that ruling, offshore trust cases almost always reference the warning that if the impossibility was the individual's own doing, the defense is defeated.

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<sup>25</sup> Evan Metaxatos, *Comment Thunder in Paradise: The Interplay of Broadening United States Anti-Money-Laundering Legislation and Jurisprudence with the Caribbean Law Governing Offshore Asset Preservation Trusts*, 40 U. Miami Inter-Am L.Rev. at 177.

<sup>26</sup> Barry Engel, *Comments at Roundtable Discussion at Vanderbilt University School of Law*, 32 Vand. J. Transnat'l L. at 831.

<sup>27</sup> 179 F. 3d 1228 (9<sup>th</sup> Cir. 1999).

<sup>28</sup> *Id.*

“Offshore trusts do not provide a wall of protection.”<sup>29</sup> Experts expect that the courts “will order defendants to ... repatriate the assets without revealing that they are involved in a lawsuit.”<sup>30</sup> In fact, if the U.S. government is the creditor, the intensity increases. The U.S. government has the resources to bring cases in foreign jurisdictions, when necessary. Further, in *Pack v. the United States of America*, the district court sustained foreclosure on property located in offshore trusts based on the alter-ego theory and fraudulent conveyance.<sup>31</sup> More recently, the in the *United States v. Grant*, the district court magistrate held the tax lien was valid, and there was essentially no difference in the trust corpus than if it were an offshore bank account.<sup>32</sup>

### 3. Difficulty accessing assets

The offshore trusts, by definition, are physically located outside of the U.S. and its territories. By design, access is difficult and cumbersome. For some users, the whole point is to make the access by creditors a challenge. For others, that matters less, and they engage in the offshore trusts for a whole host of other reasons. Regardless of the motivation, accessing the assets can be time-consuming. With modern technological innovations, some of the barriers have been removed, and physical travel to the trust situs is no longer required. Electronic debits and wire transfers allow some assets and trust income to be brought on-shore to the U.S. quickly, and thus triggering a potentially taxable event just as quickly. Also, language can be a barrier to moving assets. Therefore, some attorneys recommend selecting a trust site that uses English as an official language<sup>33</sup> or has an official language in which the settlor is proficient.

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<sup>29</sup> *Offshore Trusts: The Creditors' Hurdle is Lowered: Significant Trends and Innovations in Estate Planning*, 24 Tax Mgmt. Est., Gifts, & Tr. J. 229 (1999).

<sup>30</sup> *Id.*

<sup>31</sup> 1996 U.S. Dist. LEXIS 1528; 77 A.F.T.R.2d (RIA) 972 (E.D. Cal. 1996).

<sup>32</sup> Doc. 2005-19927 (S. D. Fla. 2005).

<sup>33</sup> R.J. Mintz, *Asset Protection Trust of Offshore Trust* (2012), available at [rlmintz.com/asset-protection-trust-or-offshore-trust/overview.htm](http://rlmintz.com/asset-protection-trust-or-offshore-trust/overview.htm) last accessed Mar. 23, 2012.

Previously, the client could have used the offshore trust sort of like a debit account with a Visa, MasterCard, American Express, or other internationally recognized credit card, drawn from the offshore bank. In an effort to reduce money-laundering activities, the IRS summoned – and fended off a legal challenge – access to the banking records for major U.S. credit companies drawing funds from offshore accounts, including trusts, for purchases made within the U.S.<sup>34</sup> This has acted as a deterrent for those individuals who wish to remain anonymous, and likely not accurate in their reporting for tax purposes. For legitimate use of offshore trusts, the credit cards continue, but are subject to greater IRS scrutiny.

## **II. Structure of Offshore Trusts: how does it differ from a domestic trust**

### **A. The Who: Settlor, Trustee, Beneficiary, and Protector**

In the U.S., domestic trusts have at least two people performing at least three different functions. The settlor is the person who creates and funds the trust. The trustee is responsible for the care and oversight of the trust property and may be the same person, a trusted friend, or an institution. The beneficiary may be the settlor and, potentially, an unlimited number of other identified or identifiable people. For tax purposes, the settlor is typically treated as the “taxable owner when he: 1) reserves a reversionary interest; 2) retains substantial distributive controls; or 3) retains self-serving administrative controls.”<sup>35</sup> He or she may make gifts from the trust and pays income tax on the trust proceeds. Upon death, the estate of the settlor may pay the excise transfer tax based upon the value of the estate after exemptions and credits. In order to avoid some of this taxation, the settlor can lessen the “incidents of ownership,” by ceding control to beneficiaries.

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<sup>34</sup>John Hembura, *Judge Grants IRS Authority to Issue Summons Against American Express, MasterCard*, §7609, Doc 2000-28191 (Oct. 2000); and William D. Hartsock, *Offshore Tax Audits - Appeal and Litigation*, available at [www.tax.lawfirm.net](http://www.tax.lawfirm.net), last accessed Mar. 23, 2013.

<sup>35</sup> Rabkin & Johnson, *Current Legal Forms with Tax Analysis: Irrevocable Trusts*, §9.08.



By contrast, offshore trusts have at least three people performing at least four different functions. The settlor and beneficiaries (or class of beneficiaries) function largely the same as they do under domestic trusts. The trustee, however, is still implementing the trust's governing documents and caring for the assets, but in offshore trusts is almost always required to be a trust company registered within the jurisdiction. Similar to the U.S., the perception is that offshore trust companies are diligent and care for the assets as directed without emotional ties to the beneficiaries, but that they also usually charge more in fees. To that end, most offshore trust jurisdictions require or permit the designation of a protector.

The "protector is a fiduciary," charged with trustee oversight.<sup>36</sup> Often times the trust document will include a provision that the protector or committee of protectors may remove the trustee or make other administrative changes, and is required to either approve or disapprove certain acts by the trustee.<sup>37</sup> Selecting the protector is important; this person serves as the lone back-stop for the settlor, whose assets are in trust a significant distance away. Ideally, the protector is an independent person, knowledgeable about trusts, watching out for the beneficiaries' best interests. One critical challenge in selecting the protector is that U.S. citizens, who are specifically using the offshore trusts for greater asset protection, may inadvertently select a protector with ties back to the U.S. This may allow a creditor to exercise personal jurisdiction and bring a case in U.S. courts.<sup>38</sup> Protectors may or may not be a beneficiary of the trust, but to guard against self-dealing, the protector ought not have any interest in the trust.<sup>39</sup>

Offshore trusts are often heavily encouraged by another group of people known as promoters. Essentially, they function as both sales people and trusts advisors, convincing U.S.

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<sup>36</sup> *International Estate Planning, Asset Protection Trusts for the U.S. and Foreign Persons*, § 9.12: The Protector, Matthew Bender & Company, Inc. (2011).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

citizens to create the offshore trusts. They use the internet as a means of attracting potentially unsuspecting customers and are largely unregulated. The U.S. Department of Justice has brought several high profile cases, which have resulted in disbarment and permanent loss of license for attorneys and accountants.<sup>40</sup> Individuals interested in the offshore trust market need to be certain of whom they are dealing with. Many indicate that certain practices are legitimate while the “case law does not support that claim.”<sup>41</sup>

### **B. The How: Structure**

In general, U.S. trusts are an agreement to place assets in a segregated account for the use of beneficiaries either now or in the future. The legal title of trust corpus is held by the trustee; the equitable title is held by the beneficiaries. The trust may have life estates and remainder interests. Domestic Asset Trusts, now found in some form in twelve states, allow self-settled spendthrift trusts with additional asset protection. Offshore trusts are structured largely the same with a few jurisdictional variations. Because of the use of both the trustee and the protector, with whom the settlor may not have a strong relationship, many settlors use a non-binding letter of wishes to describe their intentions for the management of assets and the treatment of beneficiaries.<sup>42</sup>

Imprisonment, fines, and other penalties are most often attributed to poor trust design,<sup>43</sup> but may also be attributed to failure to report income and gifts on tax filings. Therefore, it is imperative that the trust documents be well designed, and custom to the settlor

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<sup>40</sup> *DOJ Says Georgia CPA Barred from Promoting Tax Fraud Scheme*, 2007 TNT 58-94 (Mar. 23, 2007); *IRS Raids Offshore Promoters*, 2001 TNT 45-23 (Mar. 6, 2001).

<sup>41</sup> Offshore-Trust.Net, *Offshore Asset Protection* (2010), available at [www.offshore-trust.net](http://www.offshore-trust.net), last accessed Mar. 23, 2012.

<sup>42</sup> Duncan E. Osborne, *ALI-ABA Continuing Legal Education: Asset Protection: Trust Planning*, SS010 ALI-ABA 2069, 2137 (2010).

<sup>43</sup> Richard W. Nenko, *A Comparison of Offshore and Domestic Trusts*, 38-2 Univ. of Miami Law Center on Est. Planning P 214 E 5 (2011).

and the beneficiaries. Offshore trusts have flexibility: the settlor can have a single trust, multiple trusts, private company trusts, or ancillary entities (offshore trust plus offshore corporation).<sup>44</sup> They can also use drop-down corporations (wholly-owned subsidiary corporation), sister corporations, or even “non-trusts” (similar to private foundations).<sup>45</sup> Offshore trusts may also be dynastic trusts, charitable remainder trusts, marital trusts, generation skipping trusts, and perpetual trusts.<sup>46</sup>

In a model trust agreement, a tax savings clause is included to prohibit the trustee and protector from making distributions that would result in inclusion for either estate or gift tax purposes.<sup>47</sup> Another common tool in the offshore trust industry is a flee, or flight, provision that requires the trustee to “redomicile” assets to new trusts usually in a different offshore jurisdiction if a creditor makes a claim.<sup>48</sup> The trustee has a duty to the beneficiaries to protect the assets, even if that means moving them to a different jurisdiction and effectively ending that trust relationship. The flee provision has been called the “ultimate safeguard.”<sup>49</sup>

Control is a major issue in estate tax planning, because Code §§ 2036 and 2038 require certain trust assets to be included in the gross estate at the death of a U.S. resident. Specifically, § 2036(a)(1) requires assets to be included in the decedent’s gross estate if the settlor “has possession of enjoyment of, or the right to income from the property” and (a)(2) requires inclusion if he or she has the “right to ... designate the persons who shall possess or enjoy the

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<sup>44</sup> Duncan E. Osborne, *ALI-ABA Continuing Legal Education: Asset Protection: Trust Planning*, SS010 ALI-ABA at 2136-37.

<sup>45</sup> *Id.*

<sup>46</sup> Leslie C. Giordani and Elizabeth Morgan Schurig, *Trust Deed of Settlement: Appendix 1-1 to Asset Protection: Offshore Trust Forms*, 4 *Asset Protection: Dom. & Int’l L. & Tactics* Appendix 1-1 (2012).

<sup>47</sup> *Id.* at 29.

<sup>48</sup> Duncan E. Osborne, *ALI-ABA Continuing Legal Education: Asset Protection: Trust Planning*, SS010 ALI-ABA at 2138.

<sup>49</sup> Ritchie W. Taylor, Note and Comment, Domestic Asset Protection Trusts, 13 *BYU J. Pub. L.* 163, 174 (1998).

property.”<sup>50</sup> Section 2038 will cause assets to be included in the gross estate if the settlor has the power to “alter, amend, revoke, or terminate the trust.”<sup>51</sup> Domestic asset protection trusts generally have provisions to meet these control exceptions, or when they do not, tax planning is not the primary concern of the settlor.<sup>52</sup> Offshore trusts have formation variations that allow the settlor to maintain certain controls without being subject to §§2036 and 2038.<sup>53</sup> The letter of wishes and the protector are one level of control. Appointing the settlor as co-trustee and having a duress clause, allowing the other trustee to remove the settlor in the event of a judgment, may work, but did fail in the *Affordable Media* case.<sup>54</sup> Using foreign corporations adds an additional layer to limit the trustee’s authority, so long as it is not a sham trust.<sup>55</sup>

Located roughly halfway between Hawaii and New Zealand, the remote Cook Islands serve as a hotbed for offshore trust activity and provide a key difference in the legal structure.<sup>56</sup> The International Trusts Act (1984) of the Cook Islands allows for the retained control over the trust assets.<sup>57</sup> Normally, U.S. Internal Revenue Code (Code) §2036 requires that settlor cede a sufficient amount of control or have the asset be included in the calculation of the settlor’s gross estate. Under the Cook Islands’ law, the settlor may maintain control or power over the right to revoke, dispose, amend the trust and the trust instrument, remove the trustee, maintains his or her

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<sup>50</sup> Richard W. Nenko, *Planning and Defending Domestic Asset-Protection Trusts*, SM 077 ALI-ABA 653, 713-15 (2007).

<sup>51</sup> *Id.* at 713.

<sup>52</sup> Richard G. Bacon and John A. Terrill, II, *Domestic Asset Protection Trusts Work – Should They?* 26 Tax Mgmt. Est., Gifts & Tr. J. at 14.

<sup>53</sup> Duncan E. Osborne, *ALI-ABA Continuing Legal Education: Asset Protection: Trust Planning*, SS010 ALI-ABA at 2137-38.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 2138-39.

<sup>56</sup> The Cook Islands are used to draw comparisons here, and additional jurisdictions will be discussed throughout.

<sup>57</sup> Richard W. Nenko, *A Comparison of Offshore and Domestic Trusts*, 38-2 Univ. of Miami Law Center on Est. Planning P 214 E 6 (2011).

own interest in the corpus, and may be the sole beneficiary.<sup>58</sup> All of this is in direct contrast to U.S. law.

The Cook Islands' statute also rejects foreign judgments, unless a rare treaty is in place with that nation. Judgments only from courts within the Cook Islands are recognized.<sup>59</sup> In the U.S., the Full Faith and Credit Clause requires U.S. jurisdictions to recognize the judgments of sister courts. Without either that clause or a treaty with the U.S., creditors wishing to access trust assets within the Cook Islands have to start new proceedings there. Under the legal structure of the Cook Islands, as well as many other offshore trusts havens, the new proceedings require local counsel, admitted to practice in that court system.<sup>60</sup> Local counsel is sometimes resistant to taking such cases and often will require significant retainer fees.<sup>61</sup>

Also, in a domestic U.S. trust, the creditor may be able exercise *in personam* jurisdiction over the trustee if there are "minimum contacts;" whereas, in foreign jurisdictions, trustees and protectors often have no business or personal ties to the U.S.<sup>62</sup> If the trustees and the protectors have no assets in the U.S. and cannot be served process under the Federal Rules of Civil Procedure, a creditor in the U.S. will need to go to the trust situs in order to seek judicial relief. Other cases have attempted to exercise *in rem* jurisdiction over assets located within the U.S.; however, most trustees and protectors, again, do not hold assets in the U.S. and are not subject to

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<sup>58</sup>International Trusts Act of 1984 (Cook Islands) § 13C, as *reprinted in* Richard W. Nenno, *A Comparison of Offshore and Domestic Trusts*, 38-2 Univ. of Miami Law Center on Est. Planning P 214 E 6 (2011).

<sup>59</sup> International Trusts Act of 1984 (Cook Islands) §13D, as *reprinted in* Howard D. Rosen, *The How's and Why's of Offshore Trusts in Asset Protection Planning*, 21 Tax Mgmt. Est., Gifts & Tr. J. 115, footnote 10 (1996).

<sup>60</sup> Howard D. Rosen, *Domestic Asset Trusts: Do They Really Work?* 23 Tax Mgmt. Est., Gifts & Tr. J. 211 (1998).

<sup>61</sup> *Id.*

<sup>62</sup> Richard C. Ausness, *The Offshore Protection Trust: A Prudent Financial Planning Device or the Last Refuge of a Scoundrel*, 45 Duq. L. Rev. at 163.

jurisdiction.<sup>63</sup> In *Nastro v. D’Onofrio*, the Connecticut District Court “held that it lacked jurisdiction over the trustee of a Jersey, Channel Islands, trust” despite the trust assets being limited to shares in a Connecticut corporation.<sup>64</sup> However, the IRS echoed the warning of the chairman for a Bahamian banking and investment service, “no matter how a ... trust was structured offshore, it was vulnerable because it ‘always’ has onshore connection.”<sup>65</sup> Typically, this refers to that ability to exercise jurisdiction over the settlors and beneficiaries, if the situation warrants. Offshore trusts are not “risk-free”<sup>67</sup> in that they require working with a foreign trustee corporation or bank of which a client may have little knowledge.

The cost of creating an offshore trust may prohibit some settlors for going to offshore locales. Online promoters indicate that the cost varies from \$795 in the Seychelles to about \$1500.<sup>68</sup> Though the real cost for creating a legitimate offshore account is probably closer to \$15,000. By comparison, the average domestic asset trust costs about half that to create.<sup>69</sup>

### C. Types of Assets

Depending upon the jurisdiction, an offshore trust may be funded with all the same things that a domestic trust may be. Normal trust corpus consists of cash, securities, real estate, cars, boats, antiques and works of art, copyrights and patents, pension funds, and complete

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<sup>63</sup> Richard W. Nenzo, *Home State Courts’ Ability to Disregard Selection of Trust States*, 40-4 Univ. Miami Law Center on Est. Planning P403 (2011).

<sup>64</sup> 263 F. Supp. 2d 446, 453 (2003).

<sup>65</sup> The Channel Islands refers to the Jersey, Guernsey and Sark Islands located in the English Channel separating England from France.

<sup>66</sup> Tax Analysts of Tax Notes Today, *The IRS’ Fight Against Abusive Offshore Trusts*, §671 – *Grantors as Owners*, Doc 2000-18595, 2-3 (2000), quoting Roy Bouchier, of International Trade Investments, Ltd.

<sup>67</sup> Phyllis C. Smith, *The Estate and Gift Tax Implications of Self-Settled Domestic Asset Protection Trusts: Can you Really Have Your Cake and Eat It, Too?* 44 New Eng. L. Rev. 25, 35 (2009).

<sup>68</sup> ASPI, *Offshore Companies, Banking and Trusts: Formation and Assets Protection*, available at [www.asset-protection-international.com](http://www.asset-protection-international.com), last accessed Mar. 23, 2012.

<sup>69</sup> Richard W. Nenzo, *Planning and Defending Domestic Asset-Protection Trusts*, ST 022 ALI-ABA 637, 852 (2011).

companies.<sup>70</sup> The typical offshore trust holds cash, property (including real estate) and trading companies.<sup>71</sup> Notably absent from that list are the proceeds from life insurance policies. Some jurisdictions do allow for Irrevocable Life Insurance Trusts, funded by their domestic life insurance companies.<sup>72</sup> For real estate, most jurisdictions will allow the trustee to hold legal title to the asset, though the physical asset itself may still be in the U.S. The beneficiaries are able to enjoy their equitable title, which may include physical use of the property. For example, the Cook Islands have no requirement that assets be physically located within the islands.<sup>73</sup>

#### D. Jurisdictions

Some jurisdictions have earned the moniker “Tax Havens” for having favorable tax and banking laws to attract foreign money to their locales. This is not an exhaustive list of either locales or their nuanced legal differences; however, it does serve as a starting point for understanding those differences. In selecting the site for the trust, several jurisdictions avail themselves to a variety of laws and mechanisms that may be of interest to a particular client. Careful selection based upon the client may allow for significant asset protection while precluding traditional causes of action.<sup>74</sup>

The traditional localities in no particular order are Anguilla, the Cook Islands, Nevis, St. Kitts, St. Vincent, the Grenadines, the British Virgin Islands, Gibraltar, Guernsey, Jersey, Sark,

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<sup>70</sup> APGI, *Offshore Trusts Explained: The Basics Concerning Offshore Trusts*, available at [www.asset-protection-international.com/offshore-resources](http://www.asset-protection-international.com/offshore-resources), last visited Mar. 23, 2012.

<sup>71</sup> *Id.*

<sup>72</sup> Leslie A. Share, *Foreign Life Insurance Trusts – More Bang for the U.S. Buck?* 1 Asset Protection J. 1 (1999), available at <http://www.pnrlaw.com/lasart1.htm>, last accessed Apr. 13, 2012.

<sup>73</sup> Howard D. Rosen, *Domestic Asset Trusts: Do They Really Work?* 23 Tax Mgmt. Est., Gifts & Tr. J. 211 (1998).

<sup>74</sup> *Id.*

Isle of Mann, Liechtenstein, Bermuda, Samoa, Belize, Panama, and the Cayman Islands.<sup>75</sup> For U.S. settlors and beneficiaries, a common trend is to locate the offshore trust in former British Commonwealth countries, although other countries have made themselves equally appealing. One internet-based company, promoting offshore trusts for corporations, cautions against using the British Dependencies because many charge an additional “withholding tax on bank account interest.”<sup>76</sup> In the U.S., bank interest is taxable ordinary income because the owner has immediate access to the assets.<sup>77</sup>

With regard to comity, some of the offshore trust localities have specific legislation that grants their local trusts as having immunity from foreign (U.S.) laws, including judgments.<sup>78</sup> Those include Montserrat, Anguilla, the Cook Islands, Nevis, St. Kitts, St. Vincent, the Grenadines, but exclude British Virgin Islands, Gibraltar, Guernsey, Jersey, Sark, Isle of Mann, Liechtenstein, as they do not have immunity-granting legislation.<sup>79</sup> This forces creditors seeking enforcement of a judgment to bring a fresh case in the locale. Therefore, another critical question becomes the statute of limitations. For example, in the Cook Islands, the statute of limitations is one year; whereas the statute of limitations in the Caymans Islands is six years.<sup>80</sup> Another factor in selecting trust situs is the burden required to prove a fraudulent transfer. The

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<sup>75</sup> *Id.*; Dr. Rose-Marie B. Antoine, *Caribbean Legal Affairs: Waiting to Exhale: Commonwealth Caribbean Law and Legal Systems*, 29 Nova L. Rev. at 143; B. Chad Bungard, *Offshore Banking in the British Dependencies*, 9 Touro Int’l L. Rev. at 141, 145, 170; Office of Homeland Security, *Tax Haven Abuses: The Enablers, the Tool and Secrecy*, reprinted at Tax Notes Today, 2006 TNT 147-18; Offshore Corporation, *Why Should I have my Own Offshore Corporation* (2011), available at [www.offshorecorporation.com](http://www.offshorecorporation.com), last accessed Mar. 23, 2012.

<sup>76</sup> Offshore Corporation, *Why Should I have my Own Offshore Corporation* (2011), available at [www.offshorecorporation.com](http://www.offshorecorporation.com), last accessed Mar. 23, 2012.

<sup>77</sup> 26 U.S.C. § 62(a).

<sup>78</sup> Howard D. Rosen, *Domestic Asset Trusts: Do They Really Work?*, 23 Tax Mgmt. Est., Gifts & Tr. J. at N19.

<sup>79</sup> *Id.*

<sup>80</sup> Offshore Corporation, *Offshore Trusts Provide Strong Asset Protection* (2011), available at [www.offshorecorporation.com](http://www.offshorecorporation.com), last accessed Mar. 23, 2012.



Cook Islands, Mauritius, and Nevis use “beyond a doubt” or its equivalent, setting a high standard common for most of the localities.<sup>81</sup> However, Bermuda applies “on balance of probability” standard.<sup>82</sup>

There is a natural conflict of laws between the source of the assets and the trust situs. There may be additional conflicts if the settlor or beneficiaries are located in a third jurisdiction, or there is no tax treaty between the countries. Each country wishes to have its sovereignty respected, and the cross-border transfers lead to challenges. In recent years, the public policy of the U.S. has clashed with the domestic policy of the “tax haven” jurisdictions. Heightened privacy laws exist in most of those jurisdictions, as well as in Switzerland. At a 2009 G-20 Summit, major political forces like the U.K. and Germany joined the U.S. in pressuring such countries to reign in their privacy laws.<sup>83</sup> The U.S. and the Swiss have entered into bilateral treaties. Fundamentally, the two countries remain at odds. The U.S. wants better reporting to ensure that money is not moving through the world fraudulently and without proper taxation. The Swiss want to exercise their sovereign rights and protect patron privacy in banking.

## **II. Tax consequences**

### **A. Income Tax considerations**

The lion’s shares of U.S. cases regarding the tax treatment of offshore trusts are related directly to income taxes and income tax evasion. In order to ensure that a client has the minimal understanding of the special requirements that offshore trusts pose, income tax is briefly

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<sup>81</sup> *Id.* at 6 and FN 20.

<sup>82</sup> *Id.* at FN 20.

<sup>83</sup> Beckett Cantley, *The UBS Case: The U.S. Attack on Swiss Banking Sovereignty*, 7 *BYU Int’l L. Mgmt. Rev.* 1, 3 (2011).

addressed before moving back to the focus of estate and gift taxation. “There is no strategy or technique which will alter this result without causing you to commit perjury or tax fraud.”<sup>84</sup>

### 1. Reporting Requirements

Both domestic trusts and offshore trusts require the settlors who retain control of the assets and the beneficiaries who receive trust income and gifts to report those on their annual income tax filings.<sup>85</sup> Some jurisdictions require income or other taxes on the offshore trust, and U.S. taxpayers may use those as a credit against some of their U.S. taxes.<sup>86</sup> To avoid problems, individuals ought to maintain adequate records and submit filing, accurate filings, reporting their interests in offshore trusts. Offshore accounts, including trusts, require Form TD F 90-22.1, a special filing form for U.S. taxpayers with a “financial interest in or signatory authority over” foreign accounts with more than \$10,000 during calendar year.<sup>87</sup>

New in the 2011 reporting year, individuals may have to file an additional new form – Form 8938.<sup>88</sup> This does not replace any other form but is another required reporting. As part of the 2010 Hiring Incentives to Restore Employment (HIRE) Act, Congress included the Foreign Account Tax Compliance Act (FACTA), requiring foreign financial institutions (FFIs) holding U.S. taxpayers’ account report to the IRS. In February 2012, the Treasury announced proposed regulations for those FFIs with the implementation date in June 2013.<sup>89</sup> Under this act, individual taxpayers who are beneficiaries or grantors (settlors) with “\$50,000 on the last day of the tax year or \$75,000 at any time during the tax year ... [or] are living abroad” are expected to

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<sup>84</sup> R.J. Mintz, *Asset Protection Trust of Offshore Trust* (2012), available at [rlmintz.com/asset-protection-trust-or-offshore-trust/overview.htm](http://rlmintz.com/asset-protection-trust-or-offshore-trust/overview.htm) last accessed Mar. 23, 2012.

<sup>85</sup> 26 U.S.C. § 641.

<sup>86</sup> 26 U.S.C. § 642.

<sup>87</sup> IRS, *Report of Foreign Bank and Financial Accounts (FBAR)* (Mar. 5, 2012).

<sup>88</sup> IRS, Comparison of Forms 8938 and FBAR Requirements.

<sup>89</sup> Treasury, IRS Issue Proposed Regulations for FATCA Implementation IR-2012-15 (Feb. 8, 2012).

file Form 8938 along with their 1040s in April 2012.<sup>90</sup> Married taxpayers filing jointly may double the minimum amounts to trigger the filing requirement.<sup>91</sup> Deposit and custodial accounts in offshore jurisdictions are included.<sup>92</sup> These apply to both income and estate and gift tax filing.

## 2. Tax Evasion

The IRS has quite extensively litigated cases of income tax evasion through offshore trusts. Revenue agents are particularly scrutinizing for offshore trusts that are shams and/or are being used to launder money.<sup>93</sup> By 2002, the IRS increased investigations and implemented a compliance program to eliminate abusive offshore trusts.<sup>94</sup> To prove each of its fact-specific case, the IRS and DOJ (the Government)

“must prove that [the taxpayer] (1) entered into an agreement (2) to impede, impair, obstruct, or defeat the lawful assessment and collection of income taxes, (3) by deceitful and dishonest means, and (4) that he perpetrated at least one overt act in furtherance of the conspiracy.”<sup>95</sup>

Fundamentally, the Government has to prove that there was a sham transaction. It does so by looking for four pertinent factors: 1) timing of the transfer – before or after the trust creation, 2) independence of the trustee, 3) what economic interests passed to the beneficiaries, and 4) if the taxpayer recognized a requirement to pay taxes.<sup>96</sup> When these factors are questionable, the IRS

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<sup>90</sup> IRS, *Do I need to file Form 8938, “Statement of Specified Foreign Financial Assets”?* (Jan. 25, 2012).

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> IRS *Official Links Tax Evasion to Money-Laundering Violations*, 2002 TNT 212-4 (Oct. 31, 2002).

<sup>94</sup> *Id.*

<sup>95</sup> *United States of America v. Chappell*, D.C. No CR-97-00216-GEB, (9th Cir. 2001), where the Ninth Circuit upheld the lower court ruling that the tax preparer Chappell had conspired to defraud the U.S. Treasury by filing fraudulent and false tax returns.

<sup>96</sup> *Richardson v. Commissioner, Internal Revenue Service*, T.C. Memo 2006-69, 2006 Tax Ct. Memo LEXIS 71, at 42-43 (T.C. 2006).

looks for patterns in tax preparers and may exonerate good faith taxpayers and further investigate the tax preparer.<sup>97</sup> Willful blindness and reliance are not automatic absolute defenses.<sup>98</sup>

In 2006, the IRS and the DOJ brought a case against a tax-preparer and her three colleagues, who filed false income tax returns that include the “use of phony loans and gifts to repatriate their funds [to the U.S.] while concealing it from the IRS.”<sup>99</sup> To a certain extent this explains the dichotomy of the income tax evasion cases and the estate and gift tax evasion: the charges are more likely to be income tax evasion because they are more likely to be noticed by auditors and are Constitutionally ripe. Also, the Statute of Limitations is three years, the equivalent of how far back IRS agents may review a filing.<sup>100</sup>

Offshore promoters’ schemes vary quite a bit. In 2011, the IRS filed the *U.S. v. Sunderlage* complaint, attempting to enjoin a privately held corporation and its owner-managers from operating a fraudulent scheme to induce companies to invest their “employee benefit” plans in an offshore trust and then to deduct the investments on the companies’ tax returns.<sup>101</sup> The IRS contends that Sunderlage was notified that her plan was not in compliance with federal tax law, yet continued to promote her plan and earn trust income tax-free to be used personally by Sunderlage.<sup>102</sup> When new federal law was enacted through the American Jobs Act of 2004, Section 409A was added to the Code, requiring that offshore trust income not in a qualified deferred compensation plan be taxed as ordinary income. Here, the IRS argues that Sunderlage was given notice of the amendment – or the closing of the “offshore trust loopholes” – and did

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<sup>97</sup> *Id.* at 74-77.

<sup>98</sup> *Id.* at 75.

<sup>99</sup> *Las Vegas Court Blocks Tax Preparer’s Alleged Scheme Estimated to Have Cost the Treasury \$31 Million*, 2006 TNT 231-20 (Nov. 30, 2006.)

<sup>100</sup> *Richardson v. Commissioner, IRS*, 2006 Tax Ct. Memo LEXIS at 78.

<sup>101</sup> *U.S. v. Sunderlage*, No.1:11-cv-04713 (N.D. Ill. 2011).

<sup>102</sup> *Id.*

not comply<sup>103</sup>. The case is pending but underscores the dual needs of knowing the offshore trust operators and reporting taxes properly according to the applicable law at the time of the filing.

## **B. Estate and Gift Tax Considerations**

Ultimately, clients do not save on taxes by utilizing the offshore locations and typically spend more in administration costs and reporting.<sup>104</sup> Congress authorized § 6048, requiring filing for certain foreign trusts, and § 6677, permitting the IRS and courts to assess penalties for failure to file for certain foreign trusts. Individuals with an interest in an offshore trust must indicate so on the Form 1040, and after 1996, must also file Form 3520.<sup>105</sup> Form 3520 is the Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts and must be filed separately for each foreign trust.<sup>106</sup> Specifically, individuals or joint filers must report if he or she is the owner of the trust, receives a distribution from the trust, is responsible for another qualifying event such as creating a foreign trust or the death of a U.S. resident or citizen, received more than \$100,000 from a nonresident alien or a foreign estate, or more than \$14,375 from a foreign corporation.<sup>107</sup> Penalties are increased if criminal charges, such as conspiracy, are filed.<sup>108</sup> The individual need not file if the funds were transferred to a charitable organization, the distributions were already subject to tax within the trust situs jurisdiction,<sup>109</sup> or the distribution was to a qualified deferred compensation, retirement plan.<sup>110</sup>

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<sup>103</sup> *Id.*; *Levin Announces Bill Targeting Tax Cheats*, Section 461(i) – Tax Shelters, 2007 TNT 35-33 (2007); and IRS Notice 2006-33, 2006-1C.B. 754 (2006); .

<sup>104</sup> Richard W. Nenno, *Planning and Defending Domestic Asset-Protection Trusts*, ST 022 ALI-ABA at 852.

<sup>105</sup> Senate Finance Committee, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities*, Joint Committee JCX 65-08 (2008).

<sup>106</sup> Internal Revenue Service (IRS) Instructions for Form 3520, Cat. No. 23068I, 1 (Dec. 7, 2011).

<sup>107</sup> *Id.* at 2-4.

<sup>108</sup> William D. Hartsock, *Two Promoters of Offshore Tax Fraud Scheme Plead Guilty in Oregon* (Apr. 23, 2003), available at [www.tax.lawfirm.net](http://www.tax.lawfirm.net), last accessed Mar. 23, 2013.

<sup>109</sup> Such funds are claimed on the Form 1040, Federal Income Tax filing form, and may be used as a foreign tax credit depending upon the jurisdiction.

The Code normally requires the owner of the trust file. In many instances, the beneficiaries hold ownership interests and must report. If the beneficiary provides insufficient information regarding a distribution and the IRS cannot determine if it is income or a gift, or even, a bona fide sale, the IRS will apply the default rules and include it as gross income.<sup>111</sup> Therefore, it is extremely important that the beneficiary file appropriately and provide the adequate documentation, otherwise, he or she risks being taxed at the wrong type of tax and at the wrong rate. Also, if the settlor is not a U.S. citizen or resident alien but the beneficiary is, there is no lifetime gift-tax exclusion, meaning that after the first \$13,000 of that year, the remaining gifts are taxed at 35 percent.<sup>112</sup>

The penalties associated with both failure to pay estate and gift taxes, as well as federal income tax are quite hefty. Typically, a first time offender who submits an incomplete form or fails to file will receive up to a \$10,000 fine. However, Code § 6677 permits the U.S. court system to assess penalties up to 35 percent of the of the value of the property transferred out of the U.S., 35 percent of the gross distributions made to the U.S., and five percent of the total trust assets.<sup>113</sup> In a 2003 case from Oregon, the ultimate penalty, interest, fines and the original taxes original amounted to about 61 percent of the trust corpus.<sup>114115</sup>

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<sup>110</sup> IRS Instructions for Form 3520, Cat. No. 23068I, at 2, 4.

<sup>111</sup> 26 U.S.C. § 6048(c).

<sup>112</sup> Elizabeth Ody, *Tax Hunt Pushes Global Wealthy into Offshore Trusts for Children in U.S.*, Bloomberg, March 6, 2012, available at [www.bloomberg.com/news/2012-03-06/tat-hunt-pushes-global-wealthy-into-offshore-trusts-for-children-in-u-s-.html](http://www.bloomberg.com/news/2012-03-06/tat-hunt-pushes-global-wealthy-into-offshore-trusts-for-children-in-u-s-.html), last accessed March 28, 2012.

<sup>113</sup> 26 U.S.C. § 6677; IRS Instructions for Form 3520, Cat. No. 23068I; and Senate Committee on Finance, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities*, Joint Committee JCX 65-08 (2008).

<sup>114</sup> *United States of America v. Neal, et.al*, as reported in William D. Hartsock, *Two Promoters of Offshore Tax Fraud Scheme Plead Guilty in Oregon* (Apr. 23, 2003) available at [www.tax.lawfirm.net](http://www.tax.lawfirm.net), last accessed Mar. 23, 2013.

<sup>115</sup> The penalty was 75% of the original 35% tax owed ( $35 \times .75 + 35 = 26.25\% + 35\%$ ).

Under current U.S. law, third parties, such as employers, financial institutions, and corporations giving dividends, are required to report taxable events. Each does so by filing the requisite form W-2, I-9, Form 1099, or another. Foreign persons also have a special series of requisite forms to identify their taxable events from a foreign source.<sup>116</sup> The IRS has a special Qualified Intermediary (QI) Program with some pre-determined foreign institutions that limits their reporting requirements and protects the identities of their customers.<sup>117</sup> Critics have indicated that the QI program, while sometimes effective, does not capture an estimated 78 percent of the funds flowing to offshore trusts because those are not participating financial institutions.<sup>118</sup> Given the similarities of FACTA, it may in some ways bolster the program requiring foreign financial institutions to provide greater reporting on U.S. taxpayers. The Royal Bank of Canada released its draft implementation plan in July 2011, but the U.S. and Canada have bilateral agreement to share such information.<sup>119</sup> Time and the Regulations will tell if the foreign jurisdictions voluntarily report.

### III. Repatriating an Offshore Account

#### A. Practical Reasons

Given the changes in U.S. states' trust law, individuals with interests in offshore trusts may consider migrating, or repatriating, those assets or trusts into U.S. jurisdictions with domestic asset protection trusts. By doing so, the trust may no longer be subject to the increased

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<sup>116</sup> Senate Finance Committee, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities*, Joint Committee JCX 65-08, 14 (2008).

<sup>117</sup> *Id.* at 18, 20.

<sup>118</sup> Beckett Cantley, *The UBS Case: The U.S. Attack on Swiss Banking Sovereignty*, 7 *BYU Int'l L. Mgmt. Rev.* 8-9.

<sup>119</sup> Ann Noges, Royal Bank of Canada, Letter to U.S. Department of the Treasury, *Re: Foreign Account Tax Compliance Act Provisions in the Hiring Incentives to Restore Employment Act 2010* (September 3, 2010), published in *Tax Notes Today*, 2010 TNT 216-30 (2010).

scrutiny of the IRS and it will likely have a less onerous reporting requirement.<sup>120</sup> They may be able to obtain the same asset protection as several states now allow a self-settled spendthrift trust.<sup>121</sup> Although, those state laws allow access for special creditors like the government for child support orders and for creditors who accepted those trust assets as collateral for a loan.<sup>122</sup>

Repatriating may leave the settlor and the beneficiaries more confident that the assets will be protected by the trustee, and to remove the promoter from the equation entirely. The offshore trust model requires trust on the part of the settlor and beneficiaries. The trustee and promoter are a business and an individual who must be registered and licensed within the jurisdiction and likely do not have ties to the U.S. in order to help insulate the assets. The settlor and beneficiaries may be more comfortable with U.S. law applying to the trustee if something fraudulent were to happen.

Other major factors exist for repatriating an offshore trust. Though the majority of the costs of an offshore trust occur during the creation, other costs of maintaining an offshore trust do occur and vary by jurisdiction. Political stability may be a reasonable concern for certain jurisdictions. Economic stability, especially given the current global finance situation, is another factor.<sup>123</sup> A relatively new offshore trust jurisdiction may have additional concerns such as unsettled law, pressure to cooperate or sign a tax treaty with the U.S., or may not have the human capital to implement the offshore trusts in the manner U.S. counterparts can.

## **B. Mechanics: Tax and Considerations**

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<sup>120</sup> Christopher M. Reimer, *International Trust Domestication: Migrating an Offshore Trust to a U.S. Jurisdiction*, 25 Quinn. Prob. Law Jour. 170, 172 (2012); IRS Instructions for Form 3520, Cat. No. 23068I.

<sup>121</sup> Christopher M. Reimer, *International Trust Domestication: Migrating an Offshore Trust to a U.S. Jurisdiction*, 25 Quinn. Prob. Law Jour. at 179.

<sup>122</sup> *Id.* at 180.

<sup>123</sup> *Id.* at 186.



Repatriation may occur through one of three mechanisms. Regardless of which is used, there are tax consequences. First, the offshore trust trustee may resign and, either under the governing documents or the applicable law, appoint a new trustee within the “target jurisdiction.”<sup>124</sup> Second, the assets may be transferred by the original trustee to an independent trust in the target jurisdiction through a process called “decanting.”<sup>125</sup> Finally, the trustee may terminate the trust and the beneficiaries may create a new trust.<sup>126</sup> Immediately under this third method, a taxable event occurs and the beneficiaries or the trust will need to report and pay the requisite income and gift taxes. Taxation in the first and second methods depends heavily upon the target jurisdiction. For example, some states like Wyoming with asset protection trust legislation have simplified transfer rules.<sup>127</sup> If the assets are transferred to charitable organizations or a qualified deferred compensation plan, there may not be a taxable event.<sup>128</sup>

Other factors effect to the total taxation of repatriation. Throughout the U.S., state laws vary on the treatment of trusts for state taxation purposes. Some states simply use a piggyback calculation based on the federal filing. Others require more detail. Depending upon the state jurisdiction, the tax consequences may be higher. Timing may be an issue, as state like Ohio sunset their state estate transfer tax.

#### **IV. Conclusion**

Both domestic and offshore trusts have benefits and detriments. Offshore trusts allow the settlor and the beneficiaries to take advantage of asset protections such as nonrecognition of U.S. judgments, narrow fraudulent claims definitions, short statute of limitations, flight provisions, the inability of U.S. jurisdictions to exercise personal jurisdiction over trustees, and the

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<sup>124</sup> *Id.* at 189.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at 191.

<sup>128</sup> IRS Instructions for Form 3520, Cat. No. 23068I.

additional validation of the protector.<sup>129</sup> By contrast, the domestic asset trusts found in twelve states largely offer similar protections, are tax neutral, and less expensive in terms of reporting. Additionally, they have greater certainty of law, greater access to assets when needed, and accordingly have lower risk of penalties, including imprisonment.<sup>130</sup> Sections 2036 and 2038 may inhibit the domestic trust from affording all the same retained powers.<sup>131</sup> States must recognize the judgments of sister states.<sup>132</sup>

Estate planners assist their clients in reducing their relative tax liability in ethical ways by knowing the legal restrictions within both trust and fraudulent transfer laws.<sup>133</sup> The above is not about hiding the client's assets or having secret reciprocal agreements, but rather about providing the client with an additional estate planning option. Less-than-scrupulous lawyers have been disbarred for fraudulent transfers or for concealing their participation in evasion schemes.<sup>134</sup> By plainly reporting the assets and paying the requisite taxes, a U.S. citizen can enjoy the benefits of an offshore trust. Those benefits have to be weighed against the cumbersome reporting requirements in order to determine whether an onshore, domestic asset trust would be better.

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<sup>129</sup> Richard W. Nenno, *Planning and Defending Domestic Asset-Protection Trusts*, ST 022 ALI-ABA at 849 - 50.

<sup>130</sup> *Id.*

<sup>131</sup> John E. Sullivan, III, *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes with Offshore Trusts*, 23 Del. J. Corp. L. at 484.

<sup>132</sup> *Id.* at 486.

<sup>133</sup> Howard D. Rosen, *Ethical Considerations in Asset Protection Planning*, 18 Tax Mgmt. Est., Gifts & Tr. J. 87 (1993).

<sup>134</sup> *Id.*



