

Offshore Trusts for U.S. Citizens and Residents:

SEPARATING MYTH FROM REALITY

By Joshua S. Rubenstein,
Katten Muchin Rosenman LLP



Much intrigue and glamour has historically surrounded the concept of offshore trusts – frequently administered in tropical or semi-tropical islands that

no one has heard of outside the context of adventure films. They have been touted as affording high net worth individuals everything from tax avoidance to creditor protection to complete secrecy of one's affairs. As with most things, these stories are partly true and partly fantasy. It depends on many factors.

Taxes

Offshore trusts created by U.S. citizens and residents (U.S. persons) for the benefits of U.S. persons seldom offer any tax benefits. They are almost always fully reportable on the creator's income tax returns or the trusts' own returns. They are also subject either to gift tax upon creation or estate tax upon death.

There can be tremendous tax benefits to U.S. persons who are beneficiaries of offshore trusts created by nonresident aliens of the United States. Such trusts can easily be exempt from estate taxes and, in some cases, can even be exempt from income taxes in the hands of U.S. beneficiaries. **Extreme care must be taken, however, as there can also be significant tax detriments to U.S. beneficiaries of foreign trusts – including the loss of favorable capital gains tax rates, the recognition of phantom income and the imposition of steep throwback penalties.** These advantages or pitfalls depend upon many factors, including whether the nonresident alien creator is alive, what control he or she has over the

trust, and whether there are also nonresident alien beneficiaries. Offshore trusts created by U.S. persons for the benefit of nonresident aliens of the United States can be exempt from income taxes, but they will be subject to gift or estate tax upon creation.

Creditor Protection

Generally speaking, in the United States trusts can almost always be created to be exempt from the beneficiaries' creditors. **The challenge lies in creating a trust that is exempt from the creator's own creditors.** A few states have enacted legislation that purports to permit such trusts, but the legislation is quite new and largely untested. **Depending upon the law of the local jurisdiction chosen, offshore trusts can, in fact, be exempt from the creditors of the creator, but with a series of caveats.** Such trusts are never exempt from existing creditors, either known or reasonably knowable. To avoid problems of proof as to whether or not a future creditor was known or reasonably knowable, most jurisdictions do not protect trust assets against claims of creditors brought within a short period of time of the trust's creation – generally ranging from six months to two years. Also certain kinds of claims, like matrimonial claims, are almost never covered within the creditor protection offered by such trusts. However, all such trusts should work very nicely to protect trust assets against future creditors brought beyond the initial limitations period.

Secrecy

The real question is secrecy from whom and about what? Offshore trusts can be secret from the general public. In some instances they can be structured to be secret from the intended beneficiaries, but stated beneficiaries always have rights of differing degrees depending upon the jurisdiction chosen. In terms of being secret from governmental reporting, the answer is generally no. **Almost all reputable jurisdictions have information exchange agreements with the United States.** All are also subject to various money laundering legislation that requires significant due diligence to be conducted prior to taking on a new trust. **There can be steep civil and criminal penalties for nonreporting and all U.S. persons with interests in offshore trusts have annual filing requirements, even if no tax is due.**

Other Factors

Perhaps the most interesting feature afforded U.S. creators and beneficiaries of offshore trusts is the ability to diversify one's investments to include ownership of foreign investments not otherwise directly available to U.S. persons, since the legal title holder to the investments would be the offshore trustee, not the U.S. creator. Other attributes are the ability to create perpetual trusts (which can be done in a small number of states in the United States) and access to different world-class money managers and professional trustees not available in the U.S. Of course, **the creation of offshore trusts is typically much more expensive than standard U.S. trusts, and one should determine whether the cost of creating and running such trusts is more or less than the cost of maintaining insurance to cover the taxes or potential liability that is sought to be avoided.** Most important, obtain independent legal and tax advice from someone who practices in this area and who is unconnected with any particular financial product that is being offered, so that you can properly assess its suitability for you. ■

CIRCULAR 230 DISCLOSURE: Pursuant to Regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

Joshua S. Rubenstein is a managing partner at Katten Muchin Rosenman in New York. He handles a wide variety of private client matters on a local, national, and international level, including personal and estate planning, the administration of estates and trusts, and contested Surrogate's Court and tax proceedings for high net worth individuals, professionals, entrepreneurs, artists and others with unique intellectual property interests, and is a frequent lecturer and author on these topics. Mr. Rubenstein is an adjunct professor at Brooklyn Law School and is the author of the LexisNexis Answer Guide on New York Surrogate's Court Practice. Among other prominent publications Mr. Rubenstein has been listed as one of the "Top 100 New York Super Lawyers" in the New York Times; one of the "Top 100 U.S. Attorneys" by the Robb Report, Worth Magazine; and one of the "Top 100 International Wealth Advisors" by Citywealth (a U.K. weekly).

Katten

KattenMuchinRosenman LLP

www.kattenlaw.com

401 S. Tryon Street
Suite 2600
Charlotte, NC 28202-1935
704.444.2000 tel
704.444.2050 fax

525 W. Monroe Street
Chicago, IL 60661-3693
312.902.5200 tel
312.902.1061 fax

5215 N. O'Connor Boulevard
Suite 200
Irving, TX 75039-3732
972.868.9058 tel
972.868.9068 fax

1-3 Frederick's Place
Old Jewry
London EC2R 8AE
+44.20.7776.7620 tel
+44.20.7776.7621 fax

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel
310.788.4471 fax

575 Madison Avenue
New York, NY 10022-2585
212.940.8800 tel
212.940.8776 fax

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
650.330.3652 tel
650.321.4746 fax

1025 Thomas Jefferson Street, NW
East Lobby, Suite 700
Washington, DC 20007-5201
202.625.3500 tel
202.298.7570 fax

Katten Muchin Rosenman LLP is a Limited Liability Partnership including Professional Corporations. London Affiliate: Katten Muchin Rosenman Cornish LLP.