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White Paper
Offshore Trusts

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Offshore Trusts

What is an offshore trust?

An offshore trust (sometimes called a foreign trust) is a trust that is established in a country other than the United States. Most people set up an offshore trust to try to protect their assets against present or future creditors. Typically, the trust will be set up in a country that does not recognize judgments from U.S. courts. Many people also look for countries that have a more protective (for the debtor) statute of fraudulent conveyances. A fraudulent conveyance is the transfer of an asset with the intent to hinder, delay, or defraud creditors. Each state in the United States has a statute of limitations within which a creditor or bankruptcy trustee can void the transfer. Most of the foreign countries in which these offshore trusts are set up have either a very short statute of limitations for fraudulent transfers or no statute of limitations at all. Some of the more popular countries that financial and estate planners use are the Bahamas, the Cayman Islands, Bermuda, Belize, Jersey, Liechtenstein, and the Cook Islands.

Therefore, it may be very difficult for either a creditor or a bankruptcy trustee to make a claim against the assets in one of these offshore trusts. To attack the assets in an offshore trust, the creditor or bankruptcy trustee usually must bring a separate action within the country where the trust is established. Litigating in a foreign country can be extremely costly and time-consuming. There can be substantial discovery costs, large travel and communication expenses, expensive local attorneys, and other costs not associated with trying a case in the United States.

Many of these foreign countries also allow the formation of self-settled trusts with spendthrift provisions. This means that the grantor of the trust (the individual who creates the trust) can protect the assets against creditors and still retain a beneficial interest in the trust. If at some point in the future you need either trust principal or income, the trustee can be authorized in the trust document to make these distributions to you. Of course, there are significant costs and tradeoffs to setting up an offshore trust. The cost of setting up these trusts can be significantly higher than for trusts in the United States. Local attorneys in the country where the trust is located usually have to be hired to draft the trusts. A foreign custodian may be needed to physically hold the assets, an investment manager may be needed to invest the assets, a U.S. attorney will have to be hired, and you may need a U.S. agent for tax reasons. You may also have to travel to the country to sign all the necessary documents. Furthermore, there may be substantial annual fees to maintain the trust in a foreign country.

Another tradeoff to setting up an offshore trust is that you will usually have to name an independent foreign person or entity (a trust company, for example) as the trustee of the trust. In almost all cases, the foreign trustee will then be given exclusive control over the assets in the trust. Giving up control over the trust makes many people uneasy, especially when the trust, trustee, and assets are all domiciled in a foreign country far from the United States. In addition to a trustee, some people will appoint a protector--essentially a committee of one or more persons who will have the power to direct the distribution of assets from the trust or to change the trustee. If you, as the creator of the trust,

retain some control over the assets in the trust, you run the risk that a court or bankruptcy trustee in the United States could order you to exercise your right under the trust document and transfer assets back to the United States to satisfy a judgment or creditor. This result would negate the purpose of setting up a foreign trust.

In addition to the cost and difficulty in setting up an offshore trust, there can also be significant tax complications. For U.S. income tax purposes, almost all these offshore trusts are considered grantor trusts. This designation means that you, as the creator of the trust, must report all income that the trust generates on your income tax return, whether or not it is distributed to you. Furthermore, under Internal Revenue Service (IRS) rules, if you are a U.S. citizen, you must report all income that you earn anywhere in the world, including income from one of these offshore trusts. The trust cannot be used to shelter income from U.S. taxes. Most of these offshore trusts are also set up to avoid gift taxes when transfers are made to the trust. As a result, when you die, the full value of the assets in the trust will have to be included in your gross estate for estate tax purposes. For these reasons, an offshore trust does not offer income or estate tax benefits to the grantor.

Caution: Furthermore, in recent years, the IRS has enacted complex rules to discourage U.S. citizens from setting up these offshore trusts. In certain cases, you may have to report a taxable gain when you transfer appreciated property to the offshore trust. You must also report to the IRS the creation of an offshore trust, the transfer of any assets to an offshore trust, and the death of the grantor of an offshore trust. There are stiff penalties if you fail to report any of these occurrences. After you die, any distributions to beneficiaries of the trust will be considered foreign capital gain, which is taxed as ordinary income. In conclusion, there are no income or estate tax benefits to setting up an offshore trust. In fact, there may be added income and estate tax liabilities and other significant costs to establishing one of these trusts.

How are offshore trusts governed?

Offshore trust must be set up in accordance with laws of country in which trust is established

To set up an offshore trust, you must comply with the laws of the country in which the trust is established. In almost all cases, you will need to hire an attorney in that country who has experience in drafting an offshore trust document. The attorney will not only draft all the necessary documents, but should also render an opinion that the trust is a valid one, is protected from your creditors, and is not subject to local taxation. The local attorney will also usually verify that all local legal requirements have been met.

Example(s): After consultation with your financial planner and estate planning attorney in the United States, you decide that you would like to set up a trust in a foreign country. Your attorney recommends setting one up in Belize. You will need to hire an attorney in that country

who has experience in drafting this type of trust document. You will most likely have to go to Belize to sign all the necessary documents.

Foreign trustee must be selected

You must select a trustee in the country in which the trust is established. Typically, the trustee will be a bank or trust company that has experience handling these types of trusts. In some cases, an individual (usually the attorney who drafted the trust) may be named as trustee. Some people may be very uneasy about giving exclusive power over the trust assets to a foreign trustee. To allay this concern, most countries allow the appointment of a protector (or protectorate). A protector is a committee of one or more persons who are given the power to distribute the assets in the trust, change the trustee, or even move the trust to another country.

Caution: U.S. citizens should not be named as protectors. Otherwise, a U.S. court or bankruptcy trustee may order the protector to transfer assets back to the United States. For the same reason, the grantor should not be named as a protector.

Foreign custodian must be selected

In addition to a trustee in the foreign country, you may also have to select a custodian who will actually hold the assets in the trust. With many offshore trusts, the assets may actually be held by a custodian in a different country than the domicile of the trust. Typically, the assets will be held in one of the traditional banking centers such as London, Geneva, or Zurich. A bank, trust company, or independent custodian may actually hold the assets. If the assets are to be actively managed, then you may also have to hire a foreign money manager to invest the assets for you.

Example(s): After establishing your offshore trust in Belize, you decide that a custodian located in Geneva, Switzerland, will actually hold the assets that you have transferred to the trust. You have selected one of the large, established banks in Switzerland to be the custodian. The bank, in turn, retains a professional money manager located in Geneva to invest the assets in the trust.

U.S. advisors may have to be hired

You may also have to hire attorneys, accountants, and agents in the United States to help you with an offshore trust. An estate planning attorney may be needed in the United States to coordinate the offshore trust with your entire estate plan and help you transfer assets overseas. A tax attorney or tax accountant may be needed to file tax returns and handle other tax matters for the trust. Finally, an agent in the United States may have to be appointed for certain income tax purposes.

Grantor must represent that a transfer into a trust is not a fraudulent transfer

Nearly all the foreign countries that allow the formation of these trusts require that the creator of the trust represent that the transfer of an asset to the trust is not a fraudulent transfer. In other words, the countries want some assurance that the purpose of the trust is not to defraud your existing creditors.

Example(s): You have been sued by one of your business partners, who has obtained a judgment against you for \$3 million. You immediately try to set up an offshore trust to which you plan to transfer all of your assets to protect them from your judgment creditor. However, the foreign country where the trust is located requires you to sign a representation that the transfer of assets to an asset protection trust is not a fraudulent transfer. In this case, you could not truthfully sign such a representation. However, if you had set up and transferred assets to the offshore trust many years earlier, then the assets would most likely be protected from the judgment creditor.

Why use an offshore trust?

Offshore trust may protect assets from creditors

The only reason most people set up a trust in another country is to protect their assets from a judgment creditor or in case of a personal bankruptcy. In many instances, a trust set up in a foreign country can provide a substantial barrier against the collection of debt by a creditor in the United States. As noted, these types of trusts are established in countries that do not recognize judgments from U.S. courts. To make a claim against the assets, your creditor would have to file a legal action against you in the country where the trust is located. There may be substantial barriers and costs to bringing a lawsuit in a distant country. Even a bankruptcy trustee in the United States may be powerless to collect assets in the trust.

Many foreign countries have debtor-friendly fraudulent conveyance laws

In the United States, most states have fraudulent conveyance laws where a transfer can be set aside and the asset claimed by a creditor. Most states usually have a fairly long statute of limitations within which a creditor may make a claim that a fraudulent transfer has taken place. However, most of the foreign countries have either a very short statute of limitations or no statute of limitations at all. Therefore, if you are concerned that you may be subject to a lawsuit in the future, you may want to transfer assets to one of these offshore trusts.

Many foreign countries have strict secrecy and confidentiality laws

Many of the foreign countries where offshore trusts are established have strict secrecy and confidentiality laws. If one of your creditors tried to obtain information about the trust, local laws would almost certainly forbid the trustee from disclosing any information about the trust. In contrast, in the United States, once a lawsuit has been filed, an individual may have a much easier time obtaining information about the trust or the assets in the trust.

Disgruntled heirs may have a more difficult time challenging offshore trusts

If one of your disgruntled heirs tries to challenge the soundness of your mind when you created the offshore trust, he or she may have a more difficult time succeeding than if the trust were set up in the United States. To prove that you were not of sound mind, a disgruntled heir would have to bring an action in that foreign country. They would have to hire an attorney in that country, transport witnesses to that country, and incur other substantial expenses. In some countries, you even have to post a bond to cover court costs before an action can be commenced. Furthermore, many offshore trusts can be drafted so that the trust and the trust assets can be moved to another country on short notice. If it appeared that one of your expectant heirs might be successful in his or her attack, you could simply switch the trust to another country and force your expectant heir to chase you there. In contrast, a disgruntled heir may have an easier time in the United States challenging your mental state at the time you created a trust. If successful, your heir could force a trust established in the United States to be dissolved.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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