An offshore trust can protect your assets

By Stephen H. Telford

Are you concerned with the risk of liability exposure, particularly to your business or profession in today's increasingly litigious society? If so, you may want to consider one of the newest tools in asset protection, the offshore trust.

What is an offshore trust? Basically, it is a trust which is established in a country outside the United States with laws favorable to an individual desiring to protect his or her assets from unwanted creditors.

Some countries provide better protection than others. As a result, the country to be used for establishing an offshore trust should be carefully selected.

One key factor is the time period imposed for setting aside transfers of assets under a particular country's fraudulent conveyance laws. Such laws are designed to prevent individuals from transferring assets to intentionally avoid creditors' claims.

Most fraudulent conveyance laws do not allow individuals to transfer assets when claims are pending or where the transfer bankrupts them. Consequently, assets should be transferred into an offshore trust while an individual is financially sound and no claims have been asserted or the assets remaining in the transferring individual's name are sufficient to cover any pending claim.

There are other circumstances where a transfer of assets may be considered fraudulent under a particular country's laws, and such factors should be carefully analyzed in deciding whether to create an offshore trust for asset protection.

Other options

There are several things which can be done to protect assets short of creating an offshore trust. For example, a good liability policy covering the types of risk assumed by an individual on a daily basis can go a long way to providing asset protection. In taking advantage of such protection, the policy should be reviewed to make sure it actually covers the anticipated risks and to ascertain whether it pays for all defense costs without unexpectedly reducing the desired policy limits.

The creation of an entity, such as a corporation, a limited liability company or a limited partnership, either for conducting business or for holding assets, can also provide effective protection against unwanted creditors, particularly where other investors hold an interest in the entity. Such an entity will be respected under Idaho law as long as the owners have property capitalized the entity and they have consistently treated it as an enterprise completely separate from their personal pursuits.

An individual's home can be a source of limited protection, too. Under Idaho law, an individual is entitled to an exemption for his or her principal residence in the amount of $50,000. This type of protection is called the homestead exemption. In certain circumstances, the homestead exemption can be waived by an individual for the claims of selected creditors, such as where an individual places a mortgage against his or her residence. Retirement benefits may also be entitled to some protection under Idaho statutory law.

Offshore trust options

If an individual's asset protection concerns cannot be adequately met by these commonly available means, use of an offshore trust should be considered. When an offshore trust is created for assets protection, the goal is to make it a "tax neutral" event. In other words, there should be no transfer tax implication, and the tax treatment of income should remain the same.

However, there is a question concerning how the transfer of property into the offshore trust should be treated for transfer tax purposes. The issue is whether the transfer should be treated as a completed gift subject to gift tax or whether it should be considered an incomplete gift which is included in the transferring individual's estate upon his or her death.

If the offshore trustee has the ability to return the assets of the trust to the individual creating the trust, but neither that individual nor that individual's creditors can force a return of the assets without the trustee's approval, the initial transfer of assets into the offshore trust is a completed gift which will be taxable unless the unified credit of the individual is available for use or the transfer is within the annual gift exclusion amount.

The main step in accomplishing an "income tax neutral" result is to draft the offshore trust so that it will be considered a grantor trust under income tax rules in the Internal Revenue Code. A grantor is the individual creating the offshore trust. The idea is to have the income from the offshore trust taxed to the grantor.

There are several ways to create a grantor trust, but great care should be taken to select the best method to achieve the individual's asset protection and estate planning goals. Recent legislation passed as part of President Clinton's Small Business Job Protection Act has made obtaining grantor trust status more difficult than it has been in the past. The amendments in the Act favor the use of property with little or no appreciation, such as cash, as the asset to be placed into the trust. Before any asset is transferred into an offshore trust, the Act's effect on the transfer must be carefully considered and meticulously analyzed. Certain reporting requirements will also be imposed on the grantor by the Internal Revenue Code, with substantial penalties for failing to comply.

There are potential disadvantages to be weighed when considering the use of the offshore trust as a form of asset protection. The individual's lack of control over distributions from the trust and other administrative responsibilities and functions provides the asset protection. Thus, the more control an individual retains over such decisions, the less asset protection will be available to him or her. Consequently, an individual must feel very comfortable with the offshore trustee who will be in charge of holding and managing the assets of the trust. In addition, an individual must consider that the offshore trustee will most likely invest the assets of the offshore trust in foreign securities markets and other similar investments.

These types of investments will not receive the protection provided by various governmental institutions and laws in the United States, such as the State of Idaho's Department of Finance or its "blue sky" laws and regulations, or the Federal Deposit Insurance Corporation or the Federal Securities and Exchange Commission and any of the corresponding laws and regulations. The cost of establishing and maintaining an offshore trust may also discourage its use.

The offshore asset protection trust can also be used as an estate planning tool, either alone or in conjunction with other estate planning tools. For example, an offshore trust could be used as the main mechanism for taking advantage of the annual gift tax exclusion, the unified credit or the generation skipping transfer tax exemption.

An offshore trust could also be used in conjunction with a family limited partnership. In such a situation, most of the partnership interests could be held by the trust as a limited partner. As a limited partner, the trust only has a financial interest. The individual creating the offshore trust could retain the right to manage the assets as the general partner. If an unwanted claim ever arises, a distribution could then be made, with the majority of the assets going to the offshore trust. If the right offshore jurisdiction has been selected, the time limit for trying to set aside a transfer of assets into the offshore trust under any applicable fraudulent conveyance statute in Idaho or elsewhere will begin from the moment the assets were first placed in the family limited partnership and not when the distribution of such assets was made to the offshore trust.

If you are in a high-liability risk profession or business and you have accumulated substantial assets in your investment portfolio which deserve protection, you may want to take a look at the offshore trust possibilities. For more information, see a qualified tax professional and advisor.

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