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## Tax Law

### IRS scrutiny causes affluent to consider domestic solutions

U.S. taxpayers are concerned about the increased scrutiny of foreign accounts and trusts by the Internal Revenue Service. The concern is well-founded as many of the accounts and the income earned on the assets have not been reported to the IRS.

Many Americans created foreign trusts and accounts for legitimate asset protection purposes and not for tax avoidance. The structure provides tax-neutral asset protection. Income flow through the investment entities, usually partnerships, and the creditor-proof trusts, technically “grantor trusts.” People who fund trusts are required to report all income as if they earned the income directly.

Foreign trusts are generally effective to protect assets from claims by creditors of the beneficiaries, including the individual who set up and funded the trust. For example, if a surgeon had a malpractice claim that resulted in a judgment, the creditor would have to pursue the assets in the offshore jurisdiction. This is generally expensive and time-consuming as U.S. judgments are difficult to enforce offshore. Even then, the attributes of an offshore trust generally would limit the ability of creditors to access the trust’s assets to satisfy the debt unless and until they were distributed to the debtor. This makes trusts attractive to high net worth Americans concerned about our litigious society.



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But there are disadvantages to using foreign trusts. They are more expensive than domestic trusts to set up and maintain. Some clients are uncomfortable with the logistics of dealing with a trustee in another country. A major disadvantage is the perception that offshore trusts and structures are associated with tax evaders and criminals. We have all heard of the speculation — notwithstanding the high-dollar forfeiture of a high-profile Ponzi scheme operator — “they have probably socked away millions offshore.”

This concern is much more important these days given the newly aggressive IRS scrutiny of UBS and other foreign banks and applying pressure on them to reveal information on their U.S. clients. Even though many U.S. taxpayers may have been fully compliant by reporting their accounts and income, they are concerned they now will be grouped with the noncompliant taxpayers. Because of the scrutiny, they may retain professionals to deal with an IRS auditor as the agency wades through all the U.S. clients of foreign banks and unrelated issues on their income tax returns that would not have arisen if they did had no foreign accounts or trusts.

As a result, people looking for asset protection are reconsidering domestic options. Asset protection is available through domestic structures using family limited partnerships and domestic trusts. Family limited partnerships provide significant protection to the partners from claims by creditors. Under Florida law and some other jurisdictions, a judgment creditor can get a charging order only on the partnership interest owned by the debtor. This is generally effective to avoid the seizure of partnership assets until they are distributed to the debtor. In fact, Florida limited partnerships often are used in offshore structures to hold investment assets.

In addition, a few states provide for trusts that protect the settlor's interest similar to the protection afforded by an offshore trust. Under most U.S. jurisdictions, a beneficiary's interest is protected from most creditors unless the beneficiary established the trust. For example, people who set up a Florida Living or Revocable Trust that holds their assets cannot rely on the protection of the trust against creditor claims.

However, states such as Alaska, Delaware, Nevada, South Dakota and Wyoming have passed laws that afford such protection. In those states, a creditor could reach the settlor's assets if they were funded within two to four years of the claim. There is some concern among practitioners that the protection offered by these states may not apply to beneficiaries who live in another state. The South Dakota statute, for example, specifically applies its protection to the beneficiaries no matter where they are living. As additional protection, these trusts usually incorporate a "change in situs" clause that can allow the trustees to convert the trust to a foreign trust in one of the offshore centers at a later date.

Many taxpayers are considering the domestic alternatives to foreign trusts and accounts to provide the desired asset protection without the tax filing and scrutiny burdens associated with foreign structures. In many cases, the desired protection can be achieved at a lower cost and with fewer complications.

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