By Barbara R. Hauser

2011: A Time to Hunker Down

A year of safeguarding wealth leads to an increased interest in creating offshore trusts

As we begin 2012, certain global concerns from 2011 continue to resonate. We're still dealing with an:

- uncertain global economy, with a focus on the troublesome European economies: Greece, Italy and Spain;

- uncertain political time: the "Arab Spring" (Tunisia, Egypt, Bahrain, Libya, Syria and Egypt again); and

- emphasis on more regulation and disclosure: the United States (Foreign Account Tax Compliance Act (FATCA) and limited amnesty), the United Kingdom (facility with Liechtenstein and agreement with Switzerland) and Switzerland (bank accommodations on secret accounts).

How have wealthy individuals around the globe reacted to these concerns? By focusing on protecting their family wealth. Current U.S. jargon would categorize this as an interest in asset protection trusts, but the scope of those global concerns is much broader and includes:

- An extremely elevated interest in creating offshore trusts.

- An extremely decreased interest in complex investments.

- A "banding together" of like-minded communities.

- A "banding together" within extended families.

All of these are elements of succession planning and are good news for advisors around the world.

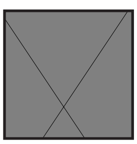
Private Wealth Global Concerns

Global families are worried about protecting assets from more than personal potential creditors. They want to protect their private wealth from: the big banks, risky investments, complicated structured product investments, private equity funds, hedge funds, funds of any sort, country-specific economic risks, country-specific political risks, country-specific currency risks, third-party fees, penalties for unreported accounts, heavy tax jurisdictions (the United States, the United Kingdom and France), heavily regulated jurisdictions and internal family conflict. If a rising tide lifts all boats, then a persistently unpredictable ocean storm causes all to "batten down the hatches."

True Offshore Trusts

One trend in 2011 was a marked increase in offshore trusts around the world. When a client lives in a non-trust jurisdiction (for example, most of Western Europe, all of the Gulf Region or all of South America), there are serious initial questions about trusts.

The central problem for the client is the idea of giving up control over his assets. The client wants to know what that means and how much control he can keep. These are issues that also arise in the United States, but the difference in degree is considerable, as individuals in non-trust jurisdictions aren't at all familiar with the trust concept. In fact, in the civil law (that is, not English-based common law), a core principle is "unity of ownership." Thus, the concept of splitting ownership into a "legal" piece and a "beneficial" piece is counterintuitive. This means that "sharing"



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ownership is also an alien concept.

A second key principle in civil law countries is that children automatically have vested rights in their parents' assets. As another example, under Shariah law (a "personal" law that applies wherever a Muslim individual lives), children also have vested inheritance rights (for example, the Sunni believers follow the rule in the Qur'an that sons receive twice the share of daughters). The idea that a trust can be used to alter or postpone those inheritance rights is a very "foreign" concept.

On the other hand, clients in those non-trust countries had a heightened awareness during the stormy events of 2011 about how easy it could be to lose their accumulated family wealth. The wish to put some of the wealth in a safe place for the future needs of the family leads quite logically to considering the use of a trust.

The increased interest in trusts has also resulted in the surfacing of a number of non-deliberate U.S. citizens.

A planning difficulty (in addition to splitting ownership and altering fixed inheritance rights) is how to deal with assets that are situated within a non-trust jurisdiction. How can those domestic assets be transferred to a trust?

If your client resides in a civil law country that has ratified the Hague Convention on the Law Applicable to Trusts and on Their Recognition, then in theory your client should be able to transfer his domestic assets to trusts, even without the existence of any domestic trust law. Those countries currently include Italy, Luxembourg and Switzerland. Switzerland, even though it has no trust law of its own, remains a leading jurisdiction for the management of offshore trusts, with more than 6,000 private trust companies.

Other countries that are marketing their trust capabilities include:

- Singapore, which is generally thought to profit as a favored jurisdiction as a result of some of the bank confidentiality problems recently experienced by Swiss banks;

- Dubai, which has also been promoting its new trust law (although many advisors are wary of new trust laws, preferring those jurisdictions with a reliable history of trust law and interpretations);

- China, which has tried adopting a new trust law, although some have commented that the Chinese word for "transfer" (of ownership to the trustee) is actually a much weaker word ("entrust") that's used for simple agencies; and

- Bahrain, which also added its own trust law, but suffered some political instability during 2011.

A final warning is that whatever jurisdiction is chosen for the governing law, the jurisdiction to keep in mind is the one where claims are likely to be made. For example, no matter how well-written the trust document, how reputable the trustee and how fine the chosen jurisdiction for the governing law—if the trust owns a home in a non-trust country, such as Spain, the local court is unlikely to recognize (or enforce) that ownership. (One solution is to convert the real property into a foreign corporate entity and to transfer those intangible shares to the trust.)[1]

Non-Resident U.S. Citizens

The increased interest in trusts has also resulted in the surfacing of a number of non-deliberate U.S. citizens (those who have dual citizenship with their home country). These children were typically born while their parents were graduate students in the United States. The United States applies two approaches to citizenship: "blood" and "dirt." So, merely being born in the United States conveys U.S. citizenship, regardless of whether an individual ever uses it. U.S. citizenship, of course, carries with it the obligation to report and pay U.S. income tax on all income, wherever it was earned. In these cases, usually the

whole family lives in their home country and may not have any U.S. investments (which is increasingly true, as the U.S. reporting regulations continue to become more stringent). This means that the family's only tax tie to the United States is that a child was born there. It used to be standard advice to have the child consider giving up U.S. citizenship (of course, since 2008, the exit tax would apply).[2]

However, the political uncertainties in many home countries make individuals quite reluctant to give up their U.S. passports. (As an aside, there seemed to be an increase in 2011 in the number of pregnant women from unstable countries who went to Canada as tourists and gave birth, thereby obtaining Canadian citizenship for their children. It was also reported during 2011 that a significant number of pregnant women from the People's Republic of China were paying a middleman a package fee to enable them to deliver the child in a Hong Kong hospital, to obtain that citizenship).

Now the phrase "offshore trusts" doesn't apply solely to U.S. taxpayers who want to postpone or avoid taxes. The narrow, but increasingly important, category that requires more attention is the true foreign family with some non-deliberate U.S. citizen family members. These families may well be creating their first offshore trust for the reasons described above. If they also have a non-deliberate U.S. citizen individual in the family, the standard foreign trust isn't sufficient. The trust planning needs to take into account that a U.S. beneficiary will trigger special U.S. tax treatment.

One solution for these families is to create for the U.S. beneficiary a separate trust that will be a true "grantor trust" (under the U.S. tax definition), by having the foreign parent create the trust with non-U.S. assets and keep a complete right to revoke the trust. This should mean that during the grantor's lifetime, any distributions to the U.S. beneficiary wouldn't give rise to U.S. income tax. The distributions would, however, trigger the U.S. reporting requirements as distributions from a foreign trust, which isn't pleasant news to most foreign clients.

The worse problem is what to do when the foreign grantor dies and the trust becomes an irrevocable foreign trust with a U.S. beneficiary. From that point on, any distributions would be subject to the onerous throwback rules. Some advisors recommend converting the trust into a U.S. trust at that point, but this isn't appealing to many foreign clients (their preference is increasingly to avoid tax contact with the United States). Another possibility might be for the original grantor to give another non-U.S. family member the right to revoke the trust, which could be exercised to restructure into another foreign grantor trust as to that U.S. beneficiary. Of course, anyone with a right to revoke could also actually revoke the trust and keep the assets. It's possible, though, that in many jurisdictions, the family would choose to continue the trust.

Relations with U.S. Taxpayers

The U.S. taxpayer is gaining a global reputation for being too much trouble (and risk) to bother with. It's not only Swiss banks that no longer welcome U.S. clients, but also even some firms based in London have recently adopted a policy not to have investment accounts for U.S. clients.

Private global investors now view the United States as "too much trouble" because of the increasing regulation. When a group of private investors were asked during a wealth conference in Amsterdam in 2011 about their view of the United States, there was uniform agreement that it wasn't a favored jurisdiction.

The global reaction to FATCA has been so adverse that in July 2011, the Internal Revenue Service agreed to delay the phase-in so that actual withholding wouldn't begin until 2014 and wouldn't be fully phased in until the end of that year.

Predictions For 2012

It seems unlikely that the stormy position of the European markets and the dislike of the broad-reaching U.S. regulations will settle down. For 2012, my prediction is that families will continue to be quite cautious in investing and quite interested in protecting their current wealth.

Endnotes

1. For more information on handling trusts in jurisdictions unfamiliar with the concept, *see* Jeffrey B. Kolodny, "Unpredictable Treatment," *Trusts & Estates* (November 2011) at p. 54.
2. For more information on who is and isn't a U.S. citizen, *see* Gavin F. Leckie, "The Accidental American," *Trusts & Estates* (November 2011) at p. 58.