THE WALL STREET JOURNAL.

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VOL. CXXXVII NO. 16 WE/DE ★★★ WEDNESDAY, JULY 23, 1997 INTERNET ADDRESS: http://wsj.com

Protection of Offshore Trusts Comes Onshore in Two States

by Lynn Asinof

The weather may be nicer in the Cayman Islands, but some people eager to insulate their wealth from the claims of future creditors may want to send their money to Alaska.

Under a new Alaska law, and a similar statute in Delaware, it is now possible to establish special trusts that enjoy the same kind of protection that some individuals typically look for offshore, in places like the Cook Islands in the Pacific or the Caymans in the Caribbean. Other states may follow suit.

While offshore trusts create stronger barriers, experts say, these new domestic trusts are now an attractive alternative for folks unwilling to put an ocean between themselves and their assets.

"This brings onshore what one could do offshore," says William T. Baldwin, a financial planner from Lexington, Mass. That makes it more palatable to many people who "wouldn't even consider an offshore trust."

Just who would want such a trust? Those heading offshore have been primarily business owners, doctors, lawyers and other professionals worried that huge jury awards could decimate their assets. To protect themselves against litigation, these folks have been willing to pay $18,000 and up to set up trusts in exotic locales.

But the new Alaska and Delaware trusts offer not only asset protection, but some estate-planning advantages that make them interesting to folks who are just plain wealthy. The cost is estimated to be half to two-thirds that of an offshore trust. The result: Lawyers who specialize in estate planning and asset protection are buzzing about the potential of these new tools for people whose assets are in the millions.

The Alaska statute was enacted in April, while the Delaware measure was signed into law earlier this month. Both clearly give new legitimacy to the concept of asset-protection planning. Many people have viewed as questionable the mushrooming practice of taking sophisticated legal steps to insulate family assets from lawsuits, divorce claims and other possible claimants.

"Now you have a state legislature saying this thing is good," says Barry S. Engel, a Denver, Colo., attorney who specializes in asset protection. "This is just the next step in the line of acceptance."

Despite the old seedy image, asset-protection trusts don't work for people trying to hide assets from existing or imminent creditors. A doctor sued for a botched operation yesterday won't be able to protect his assets by setting up a trust tomorrow. Someone who creates such a trust just ahead of bankruptcy or divorce is virtually asking the court to set it aside as a "fraudulent conveyance."

But asset protection won't necessarily be the prime use for the new Alaska and Delaware trusts. Many lawyers expect them to have a bigger impact in estate planning. New York attorney Gideon Rothschild goes so far as to venture that these trusts may become "the estate-planning tool of the decade."

What has caught the attention of the estate planners are provisions that allow people to retain some access to their assets while still getting them our of their estates for tax purposes. An established part of offshore trusts, this technique wasn't possible onshore until passage of these new laws.

"Before, you had to give it away to give it away" explains Mr. Baldwin. "Now you can give it away and still get it back."

Attorneys, for example, often recommend that clients gift significant amounts to their children, rather than passing it on at death. Common amounts are $10,000 (the annual amount that can pass free of gift tax to any person), $600,000 (the lifetime maximum amount that can pass to persons other than a spouse free of gift or estate taxes) or $1 million (the amount that can pass to grandchildren free of generation-skipping taxes).

Put into an irrevocable trust for the benefit of, let's say, the children, this money and its future appreciation is then out of the person's estate for good.

But, says Mr. Rothschild, even multimillionaires often balk at such a gift. " 'What! I can't afford it,' " he quotes them as saying. " 'Who knows what the future may bring. I may need this money for myself.' "

The new state trust laws are written to eliminate that fear, allowing a person establishing a trust to be a "discretionary beneficiary" without having trust assets considered part of his or her estate. If need for the money should arise, the individual can request that the trustee provide the needed funds with a trust distribution.

That doesn't mean, however, that someone can set up one of these trusts with the idea of dipping into the funds on a regular basis. Such antics would surely invite the scrutiny of the Internal Revenue Service.

Indeed, one element of uncertainty is how the IRS will view these vehicles. Differences between the two state laws could lead the IRS to take a different stance in each state.

"You have some of the very brightest minds in the business touting this thing," says Stephan R. Leimberg, professor of taxation and estate planning at American College, Bryn Mawr, Pa. "But it is not a slam dunk." It may be some time before the IRS makes its position known, he says.

Or, as Rockville Centre, N.Y., accountant Ed Slott put it, "No one has ever died with one of these."

Others, however, expect no challenge. They say the IRS sees these trusts as a way to stem the flight offshore where it is harder to collect income taxes. "We have heard that the Treasury kind of likes this," says Douglas Blattmachr, president of the newly established Alaska Trust Co. in Anchorage.

But that assumes that the income-tax side of the IRS actually discusses these matters with the estate-tax side, says Michael L. Fay, senior partner with Hale & Dorr, a Boston law firm. "This is a matter the IRS may want to test," he says. As such, he says, aggressive planners may begin to use Alaska or Delaware trusts this year, but those who want "a higher degree of reliability will wait for case law to develop."

Some of the more creative uses of these trusts may come in "layering" them with different estate-planning and asset-protection tools. For instance, Mr. Engel, the Colorado attorney, says he might use an Alaska trust that is established by an offshore trust. Mr. Rothschild says he might consider an Alaska trust that has the ability to turn into an offshore trust if it should ever be attacked. Mr. Blattmachr says Alaska trusts could be established to hold interests in family limited partnerships—a device currently used to cut estate taxes while maintaining control of family assets.

Costs and convenience should be take into consideration before setting up one of these trusts. Initial paperwork for a basic Alaska or Delaware trust might cost $10,000 or $12,000, attorneys say. Then there are the costs of administration, which start at $3,000 a year at Alaska Trust Co., and can go as high as 1% of assets.

Out-of-staters who create trusts may have to hire an additional set of professional advisers to handle legal and financial work. Then there are the logistical problems that come with conducting business long-distance.

Still, the practice of creating trusts with out-of-state homes is likely to become more common as competition for trust business heats up between states.

"As asset-protection planning becomes more and more accepted, it is just natural for states to look at this," says Mr. Engel. The winners, he says, will be not only the consumer, but also the lawyers, the trust companies and the accountants.