Keep Trusts Offshore?

This may be the best choice even if beneficiaries are U.S. citizens

By Stephen K. Vetter, partner, Kozusko Lahey Harris LLP, Washington D.C.

During the late 1990s, U.S. tax law became increasingly hostile to offshore trusts[1] that benefit U.S. taxpayers. Tax compliance and planning became much more difficult for non-grantor trusts—and new rules put more offshore trusts in the non-grantor category if they were established by a non-U.S. grantor. As a result, many trusts established by multinational families in trust-friendly tax havens for the benefit of their U.S. family members have since migrated to the United States.

Now, after major U.S. tax cuts were passed in May 2003, the reasons for foreign non-grantor trusts to become U.S. domestic trusts seem even more compelling when the intended beneficiaries are family members in the United States. The new lower tax rate of 15 percent on qualified dividends and long-term capital gains seems too good to pass up when compared to the punitive tax burden imposed on any future distributions of accumulated income to the U.S. beneficiaries should the trust stay offshore.

Nevertheless, the easy answer may not be the best answer. Staying offshore may still be the better choice. Much depends on a close look at the tax residence and financial needs of the beneficiaries, as well as the trust's current investments, investment policy and duration. Most importantly, those factors—and the tax law itself—may change over time, so a static analysis may produce misleading conclusions. The easy answer also may lead to irreversible error. A trust that tries to rebound from an ill-considered move to the United States may face a tax on the way out—a toll charge that precludes returning offshore.

BASICS

Because offshore trusts are outside the U.S. tax net, it is the U.S. beneficiaries who owe tax on the income of a foreign non-grantor trust—but only to the extent that beneficiaries receive distributions. This basic principle is implemented by the same complex system of tax rules that applies to domestic trusts, with two very important differences that address the loss of annual tax revenue from a foreign trust: A special throwback rule and an interest charge apply to any distribution from a foreign trust that is treated as passing out income accumulated in a prior year (including realized capital gains).

For trusts, the U.S. tax rules employ two key concepts: a distribution deduction and a distributable net income (DNI) calculation. Typically, a cash distribution reduces the trust's income by the distribution deduction and causes an equivalent amount of trust DNI to flow through to the recipient beneficiary as taxable income, causing the beneficiary to be taxed as though the income was earned directly. For foreign trusts, DNI is roughly equal to the trust's net ordinary income (including foreign-source income and income otherwise exempt from tax by treaty), plus capital gains, plus other taxable income. Thus, a distribution of $1,000 from a Bermuda trust that sold assets that year at a total gain of $1,200 will pass out $1,000 of capital gain income to the beneficiary.[2]

Income not passed through to the beneficiaries under these tax rules is attributed to the trust itself, leading to different tax results for foreign and domestic trusts. The foreign trust, which is taxed like a non-resident, non-citizen individual, is generally subject to tax only on income derived from U.S. sources, collected through a withholding tax. The result is that the typical offshore trust pays no U.S. income tax on its interest income or capital gains on its investments (except for a special tax regime for U.S. real estate, and a withholding tax on any U.S.-source dividends).

For the offshore trust with U.S. beneficiaries, however, this tax holiday may provide little benefit. While neither the offshore trust nor the beneficiaries are taxed currently, the economic benefits of this deferral are easily stripped away by the throwback rule and the interest charge that apply when the accumulated income (including realized capital gains) is later distributed to a U.S. beneficiary. The two rules work in concert to magnify the tax liability. The throwback rule artificially raises the applicable tax rate on the accumulation distribution,[3] by taxing the income passed out to the U.S. beneficiary at the ordinary income tax rates that would have applied if the distribution had been made in the year earned. The beneficiary cannot use the substantially lower maximum U.S. income tax rate on qualified dividends and long-term capital gains (15 percent as compared to ordinary income at 35 percent).[4]

An annual interest charge is then imposed to eliminate the benefit of paying the tax later, but note that the interest is being charged against the artificially high tax liability created by the throwback rule, as if this was the tax previously deferred.[5] In addition, the interest charge is compounded and not deductible in computing net taxable income.[6]

Taken together, the high tax rate generated by the throwback rule and the added interest charge on accumulation distributions create a tax drag that is very difficult to overcome through successfully reinvesting the deferred tax funds. The growing liability can consume the entire amount distributed to the U.S. beneficiary when the tax bill comes due. Even the final terminating distribution can disappear. What seemed like a benign or even beneficial deferral can turn into a festering liability that eats away at the original trust capital.

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ISOLATE TAINTED INCOME

Tax advisors have tried with some success to develop a cure for this disease. Generally speaking, these plans are designed to isolate the tainted income so it's not pulled out of the trust by future distributions to U.S. beneficiaries. Designing and implementing such a plan is quite a challenge when substantial income (including realized capital gains) has accumulated. For example, life insurance can be used as part of an investment strategy to prevent the accumulation of income in the offshore trust, or to reduce it somewhat in future years. But buying a life insurance policy will not

purge the taint on the income that already has been accumulated. Paying premiums on a life insurance policy out of the cash flow generated by the accumulated income does not create a deductible expense, so the deferred tax burden grows almost unabated. The severe income tax costs of the throwback rule and interest charge still are triggered when distributions are later made to U.S. beneficiaries, regardless of whether those distributions are made from policy benefits.[7] The complexity and other limiting factors associated with purchasing life insurance suggest a policy is not a miracle cure for a trust that already has the disease.

Leaving aside the placebos that foster wishful thinking, there are basically two types of plans that have been used to address the tax taint of offshore trust accumulations.

CLEANSING DISTRIBUTIONS

The most common prescription usually makes it possible for the U.S. beneficiaries to receive the value of the original trust capital—but no more. This treatment is applied in two steps over at least two years. First, one or more distributions equal to at least the amount of the total accumulated income are made to a non-U.S. person or to a separate non-US entity.[8] Such a distribution reduces the remaining income accumulation, even though the recipient will owe no U.S. tax. The distribution must be large enough to equal the current year's income and all the historical accumulations (including realized capital gains) in order to exhaust the accumulated income and remove the taint. Then, after this cleansing distribution, the remaining trust funds (that is, the original trust capital) can be distributed to U.S. beneficiaries or a U.S. domestic trust in the following tax year without carrying out any accumulated income. The distribution into the United States also can be staged over several years, or delayed indefinitely, as long as income (including realized capital gains) is paid out currently (or at least accumulations do not build up again without a plan to manage them).

> Life insurance may not be a miracle cure for a trust already afflicted with the throwback rule and interest charges.

The cleansing distribution therapy has several limitations. The timing is important, because beneficiaries receiving distributions in the same tax year are treated as receiving their allocable share of trust income items (that is, current and accumulated income) for that year—so the distributions to U.S. and non-U.S. beneficiaries have to be made in different years.[9] Careful accountings of the income accumulations (as determined under U.S. tax rules) are needed to identify the amount of the cleansing distributions.

More importantly, the distribution needed to cleanse the trust may be outsized in comparison to the intended beneficial interest of the non-U.S. beneficiaries. Put another way, the U.S. beneficiaries may view the tax plan as an economic snub. The economic imbalance sends advisors searching for a way to make the

OFFSHORE CAN BE RIGHT NEXT DOOR

Certainly there may be practical reasons to consider bringing an offshore trust onshore. Access to the U.S. courts or U.S. trust law may be useful, for example, if the goal is to modify the trust. The easy availability of trustees and advisors schooled in U.S. tax law and accounting may be desirable. Fortunately, a trust that has moved onshore for these purposes nevertheless may continue to be treated as foreign for U.S. tax purposes, making it a hybrid onshore-offshore trust. The income tax law now contains clear rules for determining whether a trust is foreign or domestic. A trust is treated as a foreign trust for federal income tax purposes even if a U.S. court has the authority to resolve substantially all trust administration issues, as long as at least one of the substantial decisions of the trust is controlled by a non-U.S. trustee, protector or other decisionmaker. The list of what constitutes a substantial decision is quite long, and certain flight clauses in the trust document also preserve foreign-tax status.

This test makes it easy in almost all cases for a former offshore trust to continue to be taxed as a foreign trust, because it requires only the continuation of some non-U.S. control, including a veto power. For example, a trust that requires the consent of a non-U.S. person for certain actions concerning accountings, claims or suits would continue to be a foreign trust for U.S. federal income tax purposes, even if it is administered in the United States. Such a trust also will avoid state income tax if even the appropriate host state is selected.

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U.S. beneficiary whole. It won't work to channel the excess amounts through a non-U.S. beneficiary who then passes the amounts along to the U.S. beneficiaries. The non-U.S. person is treated as an intermediary and the U.S.-bound payment is an accumulation distribution.[10] Making the distribution to another offshore trust also is ineffective. A later distribution from the second offshore trust to the U.S. beneficiary should be treated as a tainted accumulation distribution even if the second trust is not considered an "intermediary."[11] For families with significant philanthropic objectives, it may be feasible to distribute the excess amount to an offshore foundation.[12]

Finally, cleansing distributions may be unappealing because this method looks to the past rather than the future. It cures the effect of the prior accumulations, but does not permit any more accumulations. Offshore deferral comes to an end, and the trust may just as well be moved to the U.S. for tax purposes (except when life insurance or annuities can sufficiently contain future accumulations).

LARGER FUTURE INCOME STREAM

An alternative method, suitable only for very long-term trusts, takes almost a diametrically opposite approach. Rather than restricting the U.S. beneficiaries to the value of the original trust capital and virtually giving up on future deferral, the alternative method sacrifices the original trust capital to a final payment of taxes and interest; it also tries to maximize the duration of the deferral. Income is accumulated for several years, at least a decade. After this deferral phase, all of the current income on the larger asset base (but no more than current income, including realized capital gains) is paid to the U.S. beneficiaries, without any application of the throwback and interest charge rules (since there are no accumulation distributions).

Numbers and charts are instructive, but understate the value of flexibility inherent in staying offshore.

The goal is to allow the trust fund to grow large enough in the deferral phase so that the current annual income in the payout phase is greatly enhanced due to the larger asset base. Coordinating the trust's investments for each phase is critical to the plan's success.[13] If the trust continues this offshore plan for many years, the income stream enjoyed by the U.S. beneficiaries can be increased enough that the incremental benefit more than offsets a confiscatory tax burden at the end of the trust, that is, the complete loss of the final distribution to taxes and interest.[14] Obviously, this plan is suitable only for long-term trusts and for families with a multigenerational time horizon.

Unlike the cleansing distribution alternative, this method has been adversely affected by the May 2003 reduction in the tax rates, but positive results still can be achieved when the new lower tax rates are taken into account—if the offshore accumulation is very long-term.[15] Accumulating income offshore for 10 or 25 years, and then distributing the annual income generated from the larger asset base, provides attractive results over a 100-year trust term. (See "Offshore vs. Domestic," page 72.) The results remain attractive when dealing with trust terms in the range

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of 80-plus years, though the results become much less attractive over shorter terms.

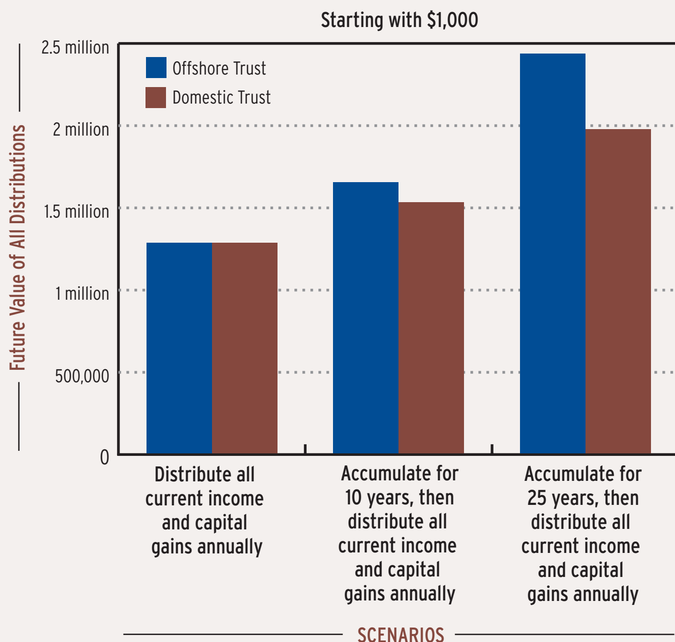
Moreover, while the numbers are instructive, they tend to understate the benefits of the accumulation method. Charts and graphs do not place a value on the flexibility inherent in staying offshore. Flexibility has value, particularly when future U.S. tax policy and rules may change before the final tax bill for the deferral comes due. Staying offshore may lead to better options in the interim.[16] For example, other, more complex techniques for addressing the tax treatment of non-U.S. trusts are available, but are not suitable for trusts of modest size. Building up the size of the trust and offering the opportunity at a future date to begin paying current income annually to the U.S. beneficiaries may make it possible to buy enough time to employ some of these other techniques.

UNCERTAINTY

The analysis should turn on more than numbers, because the real-world requires decisions in the face of uncertainty. The following factors can influence the choice between the two planning alternatives for an offshore trust, and many of these factors will be difficult to predict in a particular case:

- Is it feasible to project when the beneficiaries will need distributions?
- Are distributions of accumulated income ever likely to be needed, and if that won't occur until far in the future, what are the prospects for changes in the tax law or family circumstances by that time?
- Are there currently any non-U.S. beneficiaries, and if so, do they live in a high-income tax jurisdiction?
- Is there a power of appointment in the trust document and, if so, who can exercise it?
- Do the U.S. beneficiaries expect to ever change their tax residency or citizenship?
- Are there non-tax reasons to change beneficial interests or the trust's governance structure?
- Does the offshore trust offer more investment choices? More freedom from tax constraints in choosing investments (since the throwback rule eliminates the tax benefit of long-term gains in any event)?
- Does the trust own underlying investment companies?[17]
- Does the family have philanthropic objectives?

Deciding to remain offshore, and then choosing a plan, is significant and probably permanent. If a trust becomes a resident U.S. taxpayer, moving the trust back offshore will trigger an exit tax on the untaxed appreciation in the trust assets under Internal Revenue Code Section 684. It is entirely possible that in the future Congress will see fit to increase rather than reduce the tax consequences of such a departure from the United States. This may be enough to tip the balance in favor of staying offshore, or at least providing more than one trust locale for a given family.[18] ▮



This chart assumes:
- a 100-year trust term;
- no historic gains in the trust;
- 8 percent interest charge on tax from accumulation distributions;
- 15 percent tax rate on dividends and capital gains; 35 percent rate on ordinary income;
- 10 percent trust investment return (4 percent current yield, 6 percent capital growth); 50 percent turnover rate; 7 percent after-tax investment return outside of the trust;
- current yield is not subject to withholding during accumulation period in offshore scenario;
- current yield is taxed at a 15 percent rate in domestic scenario, and when distributed currently in offshore scenario.

The chart also includes amounts, if any, distributed at termination.

Endnotes

1. In this article the term offshore trust means a trust that is a foreign trust for U.S. income tax purposes but is not entitled to income tax treaty benefits, usually because it resides in a tax haven. See Treasury Regulation 301.7701-7(a)(2).
2. See Internal Revenue Code Sections 651, 652 and 643.

3. An accumulation distribution occurs when distributions exceed income for the current year, as measured for both income tax purposes and accounting purposes, and there is undistributed net income (UNI) in the trust from prior years, including undistributed realized capital gains. IRC Sections 643(b), 665(b), and 666(a).
4. IRC Sections 643(a)(6) and 667(e).
5. The interest charge applies to the amount of tax that was effectively deferred during the time the recipient beneficiary was a U.S. person (regardless of the beneficiary's age).
6. A 6 percent annual interest rate applies to distributions of accumulations attributed to the period prior to 1996, and that rate is compounded beginning Jan. 1, 1996. For income earned and accumulated thereafter, the varying rate under section 6621 for tax underpayments applies. IRC Sections 665(b), 667(a)(3) and 668. That rate adjusts periodically based on market rates. Over the last few years the interest charge has ranged between 4 and 9 percent. *RIA Federal Tax Coordinator*, Paragraph 2 T-8003 (2003). To overcome a nondeductible interest charge of 9 percent, the trust's investments would have to return about 11 percent if the deferral period lasted over 10 years.
7. As the premium payments do not reduce DNI, the interest charge keeps growing on the prior accumulations and the new accumulations are reduced only to the extent future economic returns are earned inside the policy rather than in the trust directly. Unless the future payments to U.S. beneficiaries can be made only out of then-current annual income as determined for trust accounting purposes, tainted accumulated income will be pulled out of the trust by future distributions. See last sentence of Section 665(b).
8. "Non-US person" means an individual who is not a tax resident or U.S. citizen. The non-U.S. beneficiaries may be within the original class of beneficiaries, or may be added by the exercise of a power.
9. IRCSection 662(b). The trustee may, however, benefit from the 65-day rule of IRC Section 663(b).
10. IRC Section 643(h).
11. It would be flatly inconsistent with the policy of the accumulation distribution rules if a pour over from one trust to another cleansed the accumulated income taint. Where the regulations have addressed similar questions, including under prior code sections, such a pour over has not been treated as a cleansing event. See Regulation Sections 1.665(b)-1A(b)(1) as well as 1.668(6)-1A(b)(1),1.668(b)-1A(c)(1)(i), promulgated pursuant to former Section 668(a). T.D. 7204, 37 Fed. Reg. 17,149 (Aug. 25, 1972).
12. This foundation would be a philanthropic trust or corporation that is prohibited from benefiting U.S. taxpayers except through clearly charitable grants that qualify as tax-free gifts, and that in any event cannot make grants to the beneficiaries of the original trust.
13. During the deferral phase, the current investment return should come from sources that are not subject to withholding, such as some corporate bonds. Investments that generate short-term capital gain also would be appropriate. During the payout phase, the investment return should come from low-tax-rate sources such as, under current law, capital gains and qualified dividends.
14. Alternatively, the final beneficiary distribution could be paid to an offshore foundation.
15. It is also important to factor in the impact of the U.S. withholding tax, now reduced to 28 percent. The beneficiary reports as income the amount actually received, increased by the tax withheld. A credit then becomes available to the beneficiary for the tax previously withheld and any excess tax withheld is to be refunded.
16. See Thomas Copeland and Philip Keenan, "How Much is Flexibility Worth?" *The McKinsey Quarterly* 1998, No. 2.
17. Offshore investment companies raise numerous U.S. tax questions, particularly the prospect of phantom income and the issue of how to attribute the share ownership. See Donald Kozusko and Stephen K. Vetter, "Respect for 'Form' as 'Substance' in U.S. Taxation of International Trusts," 32 *Vanderbilt Journal of Transnational Law* 675, 696 (1999).
18. For example, after a cleansing distribution, a trust that ends up with the historical accumulations could stay offshore while a trust with the "clean" original trust capital could come onshore.

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