Should offshore trusts stay offshore – the problems

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Introduction

US beneficiaries of foreign trusts are subject to a throwback tax regime and an interest charge when they receive distributions of accumulated income from the trust. To avoid these punitive payments, families often choose to convert or decant the trust to a US domestic trust. However, the easy answer may not be the best answer; staying offshore may be the better choice (for further details please see "Should offshore trusts stay offshore – the long-term trust solution"). Much depends on a close look at the tax residence and financial needs of each of the beneficiaries, alongside a careful examination of 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 may also lead to an 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.

Background

During the late 1990s, US tax law became increasingly hostile to trusts that were foreign for US income tax purposes but not entitled to income tax treaty benefits, usually because the trusts were created in no-tax jurisdictions outside the United States (hereinafter referred to as 'offshore trusts') and benefited US persons. Tax compliance and planning became increasingly difficult and new rules were enacted to put more offshore trusts into the category of 'non-grantor trusts' if they were established by a non-US grantor (for further details on trust classification please see "Overview (March 2018)"). As a result, many offshore trusts established by multinational families for the benefit of their US family members have since migrated to the United States.

After major US tax cuts were passed in 2003 and 2017, the reasons for foreign non-grantor trusts to become US domestic trusts seemed even more compelling when family members in the United States were the intended beneficiaries. The lower tax rate of 15% on qualified dividends and long-term capital gains seemed too good to pass up when compared with the punitive tax burden imposed on any future distributions of accumulated income to the US beneficiaries if the trust stays offshore.

US tax rules attempt to recoup lost tax plus interest on distributions from offshore trusts

Since offshore trusts are outside the US tax net, a US beneficiary who receives a distribution from a foreign non-grantor trust will owe tax on the income. No tax is owed if no distributions are made to US beneficiaries. This basic principle is implemented by the same complex system of tax rules that apply to domestic trusts, but with two 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 realised capital gains).

Key concepts

For trusts, the US 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 through the distribution deduction and causes an equivalent amount of trust DNI to flow through to the recipient beneficiary as taxable income. The beneficiary is then taxed as though the income was earned directly. For foreign trusts, the 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 and other taxable income. Thus, a distribution of $1,000 from an offshore trust that sold assets that year at a total gain of $1,200 will pass out $1,000 of capital gain income to the US beneficiary.

Income not passed out 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 US tax only on income derived from US sources, collected by means of a withholding tax. The result is that the typical offshore trust pays no US income tax on either its interest income or capital gains on its investments (except for a special tax regime for US real estate and a withholding tax on any US source dividends).

Application to offshore trusts

However, for an offshore trust with US beneficiaries, this tax holiday may provide little benefit. While neither the offshore trust nor the beneficiaries are currently taxed, the economic benefits of this deferral are easily stripped away by the throwback rule and interest charge that apply when the accumulated income (including realised capital gains) is later distributed to a US beneficiary. 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 realised capital gains.

Throwback rule

The two rules work in concert to magnify the tax liability. The throwback rule artificially raises the applicable tax rate on the accumulation distribution by taxing the income passed out to the US beneficiary at the ordinary income tax rates that would have applied had the distribution been made in the year earned. The beneficiary cannot use the substantially lower maximum US income tax rate on qualified dividends and long-term capital gains (15% compared with ordinary income at a top rate of 37%).

Interest charge

An annual interest charge is then imposed to eliminate the benefit of paying the tax later. The interest charge applies to the amount of tax that was effectively deferred during the time the recipient beneficiary was a US person (regardless of the beneficiary's age). However, notably, the interest is being charged against the artificially high tax liability created by the throwback rule, as if this was the tax previously deferred. In addition, the interest charge is compounded and is not deductible in computing net taxable income.**(1)**

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 virtually impossible to overcome through successfully reinvesting the deferred tax funds. The growing liability can consume the entire amount distributed to the US beneficiary when the tax bill comes due at that time. Even the final terminating distribution can disappear. What seemed like a benign or even beneficial deferral can turn into a mounting liability that eats away at the original trust capital.

Tax advisers have tried with some success to develop a cure for the tax drag resulting from the combination of a high tax rate generated by the throwback rule and the added interest charge on accumulation distributions from an offshore trust to a US beneficiary. Generally speaking, these cures are designed to quarantine the tainted income – that is, to isolate and seal off the accumulated income so that it cannot be pulled out of the trust by future distributions to US beneficiaries.

Quarantine tainted income to avoid distribution to US beneficiaries

Designing and implementing a quarantine plan is quite a challenge when substantial income (including realised 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 in the first instance, or can reduce it somewhat in future years, but buying a life insurance policy will not resolve the taint on the income that has already 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 are still triggered when distributions are later made to US beneficiaries, regardless of whether those distributions are made from policy benefits.**(2)** Given the complexity and other limiting factors associated with purchasing an offshore life insurance policy, it is clear that life insurance is not a miracle cure for a trust that already has the disease.

Leaving aside the placebos that foster wishful thinking (and more powerful therapies that are unusually complex), making a cleansing distribution is one of the most common methods used to attempt to quarantine UNI.

Cleansing distributions relieve prior accumulations but offshore deferral ends

Cleansing distributions usually make it possible for US beneficiaries to receive the value of the original trust capital – but no more. This is accomplished 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-US person or a separate non-US entity, who are either members of the original discretionary class of beneficiaries or added by the exercise of a power. Such a distribution reduces the remaining income accumulation even though no US tax will be owed by the recipient. The distribution must be large enough to equal the current year's income and all the historical accumulations (including realised capital gains) in order to exhaust the accumulated income and remove the taint. After this cleansing distribution, the remaining trust funds (ie, the original trust capital) can be distributed to US beneficiaries or a US domestic trust in the following tax year without carrying out any accumulated income. The distribution into the United States can also be staged over several years, or delayed indefinitely, as long as income (including realised capital gains) is paid out currently (or at least accumulations do not build up again without a plan to manage them).

Limitations of cleansing distributions

The cleansing distribution method 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 (ie, current income and accumulated income) for that year, so the distributions to US and non-US beneficiaries must be made in different years. However, the trustee may be able to make use of the so-called '65-day rule' set out in Section 663(b) of the US Tax Code allowing for the calculation of DNI after the close of the tax year followed by a final cleansing distribution that is allocated to that prior tax year. Careful accounting of the income accumulations (as determined under US tax rules) will be 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-US beneficiaries. Put another way, the US beneficiaries may view the tax plan as an economic snub. The economic imbalance sends advisers searching for a way to make the US beneficiary whole. Channelling the excess amounts through a non-US beneficiary who then passes the amounts along to the US beneficiaries will not work, as the non-US person will be treated as an intermediary and the US-bound payment will be labelled an accumulation distribution. Making the distribution to another offshore trust is also unavailing. A later distribution from the second offshore trust to the US beneficiary should be treated as a tainted accumulation distribution even if the second trust is not considered an intermediary.**(3)** For families with significant philanthropic objectives, it may be feasible to distribute the excess amount to an offshore foundation.**(4)**

Finally, cleansing distributions may be unappealing because this method looks to the past rather than the future. It relieves the effect of the prior accumulations but does not permit further accumulations. Offshore deferral ends, and the trust may just as well be moved to the United States for tax purposes (except where life insurance or annuities can sufficiently contain future accumulations).

Comment

Although the problems of keeping a trust with US beneficiaries offshore and the unsatisfactory results of cleansing distributions may lead advisers to advocate moving the trust onshore, a case can be made for an alternative solution, suitable for very long-term trusts, which takes an almost diametrically opposite approach (for further details please see"Should offshore trusts stay offshore – the long-term trust solution").The long-term trust solution maximises the duration of the deferral and then pays current income on the larger asset base. It is a solution that will be attractive to families with multi-generational time horizons, philanthropic values and sufficient wealth to provide for the current generation.

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Endnotes

(1) A 6% annual interest rate applies to distributions of accumulations attributed to the period prior to 1996; that rate was compounded as of 1 January 1996. For income earned and accumulated thereafter, the varying rate under US Tax Code Section 6621 for tax underpayments applies. That rate adjusts periodically based on market rates. Over the past few years, the interest charge has ranged between 4% and 9%. To overcome a non-deductible interest charge of 9%, the trust's investments would have to return about 11% if the deferral period lasted more than 10 years.

(2) Since 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 US beneficiaries can be made only out of the current annual income as determined for trust accounting purposes, tainted accumulated income will be pulled out of the trust by future distributions (see the last sentence of Internal Revenue Code Section 665(b)).

(3) Allowing a pour over from one trust to a second trust to cleanse the accumulated income taint would be inconsistent with the policy of the accumulation distribution rules. The pour over simply moves the accumulated income taint to the second trust. In other situations 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 generally Regulation 1.665(b)-1A(b)(1); see also Regulations 1.668(6)-1A(b)(1), 1.668(b)-1A(c)(1)(i), promulgated pursuant to former Section 668(a). TD 7204, 37 Fed Reg 17,149 (25 August 1972).

(4) This foundation would be a philanthropic trust or corporation that is prohibited from benefitting US 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.

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