Should offshore trusts stay offshore – the long-term trust solution

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Introduction

The first part of this series summarised the US tax rules that subject US beneficiaries of foreign trusts to both a throwback tax regime and an interest charge when they receive distributions of accumulated income from a trust established in a no-tax jurisdiction outside the United States (hereinafter referred to as 'offshore trusts') (for further details please see "Should offshore trusts stay offshore – the problems"). The first part of this series also examined planning to quarantine the tainted income, the cleansing distribution method and related drawbacks.

The tax drag and unsatisfactory options to deal with accumulated income often result in moving an offshore trust to the United States and giving up the tax deferral. This article proposes an alternative method, suitable for very long-term trusts, that takes an almost diametrically opposite approach. Rather than restricting the US beneficiaries to the value of the original trust capital and virtually giving up on future tax deferral, the alternative method sacrifices the original trust capital to a final payment of taxes and interest (or a gift to charity) and tries to maximise the duration of the deferral.

Long-term trusts can enhance future income stream by maximising duration of deferralf

Under this alternative method, trust income is accumulated for several years (indeed, at least for a few decades). After this deferral phase, all of the current income on the larger asset base (but no more than the current income, including realised capital gains) is paid to the US beneficiaries, without application of the throwback tax and interest charge rules (since there are no accumulation distributions).

The goal is to allow the trust fund to grow large enough during the deferral phase so that the current annual income in the pay-out 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. During the deferral phase, the investment return should come from sources that are not subject to US withholding tax, such as certain corporate bonds. Investments that generate short-term capital gain would also 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.

Unlike the cleansing distribution method discussed in the first part of this series, this long-term offshore trust option has been adversely affected by the reduction in US tax rates. However, positive results can still be achieved, even when the lower tax rates are taken into account, if the offshore accumulation period will be significantly long term. It is also important to factor in the impact of the US withholding tax. The US beneficiary must report as income the amount actually received grossed up by the tax withheld on US source income paid to the trust. A credit is then available to the US beneficiary for the tax previously withheld and any excess tax withheld is to be refunded.

Families with multi-generational time horizons
Where family matriarchs and patriarchs realise that successful wealth creation has provided more than enough wealth for the current generation, this long-term trust option allows the family to shift the focus to future generations. Similar to a trust set up as a 'family bank' and funded for a customised set of purposes (for further details please see "Family banks: personal commitment, accountability and multi-generational mentoring"), the long-term offshore trust is used by or for families with the expectation that it will financially support grandchildren and great-grandchildren. If the trust continues this offshore plan for many years, the income stream enjoyed by the US beneficiaries can be increased enough that the incremental benefit more than offsets a confiscatory tax burden at the end of the trust (ie, the complete loss of the final distribution to taxes and interest).

Families with philanthropic values
The long-term offshore trust also works well for families with philanthropic vision. The final beneficiary distribution could be paid to an offshore charitable foundation. This foundation would be a philanthropic trust or corporation that is prohibited from benefiting US taxpayers, except through clearly charitable grants to so-called '501(c)(3) organisations' that qualify as tax-free gifts, and that in any event cannot make grants to the beneficiaries of the original trust.

Jurisdictions that have abolished the rule against perpetuities are particularly attractive
Accumulating income offshore for approximately 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. The results remain attractive when dealing with trust terms in the range of 80-plus years, although the results become much less attractive over shorter terms. Thus, offshore jurisdictions that have abolished the rule against perpetuities for non-charitable trusts provide a highly attractive opportunity.

Long-term trusts provide more than just future income benefits

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 US tax policy and rules may well change before the final tax bill for the deferral comes due. Staying offshore may lead to better options in the interim. For example, other more complex techniques for addressing the tax treatment of non-US trusts are available but are unsuitable 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 US beneficiaries may make it possible to buy enough time to employ some of these other techniques.

Choices amid uncertainty

The analysis should turn on more than numbers, because the real-world choices in this context truly present the challenge of decision making under conditions of uncertainty. The following questions can influence the choice between planning alternatives for an offshore trust and many of them will be difficult to predict, depending on the 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 event is going to be significantly delayed, what are the prospects for changes in the tax law or family circumstances by that time?
- Are there currently any non-US 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 US beneficiaries ever expect to 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 or 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?
- Does the family have philanthropic objectives?

Offshore can be right next door

Certainly there may be practical reasons to consider bringing an offshore trust onshore. Access to the US courts or trust law may be useful in a given case (eg, to modify the trust). Ready access to trustees and advisers schooled in US tax law and accounting may also be desirable. Fortunately, a trust that has moved onshore for these purposes may nevertheless continue to be treated as foreign for US tax purposes (for further details please see "Establishing 'foreign' trusts in the United States"). The US income tax law contains clear rules for determining whether a trust is foreign or domestic. A trust will be treated as foreign for federal income tax purposes even if a US court has or would have 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-US trustee, protector or another decision maker. 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 since it requires only the continuation of some non-US control, including a veto power. For example, a trust that requires the consent of a non-US person for certain actions concerning accounting, claims or suits would continue to be a foreign trust for US federal income tax purposes, even if it is administered in the United States. In such cases, suitable states can be found to host such a trust without attracting state income tax.

Comment

The choice to stay offshore, and choose between the alternative plans for dealing with accumulated income, is significant and probably permanent. If a trust becomes a resident US taxpayer, moving the trust back offshore will trigger an exit tax on the untaxed appreciation in the trust assets under Section 684 of the US Tax Code. It is entirely possible that Congress will see fit in future 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 favour of staying offshore or at least providing more than one trust locale for a given family. It would also allow for more sophisticated and multi-dimensional planning. For example, after a cleansing distribution, a foreign trust that ends up with the historical accumulations could stay offshore to grow for future generations and charity, while a trust with the 'clean' original trust capital could come onshore to benefit the current generation or fund the family bank.

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