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Discuss the effectiveness and possible problems of offshore Trusts in the U.S.

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Essay

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Abstract

The US has evolved in the past decades into an explosive litigation industry involving more and more capricious legislative bodies. Entrepreneurs as well as wealthy high net worth individuals feel the need to protect and preserve their wealth through the use of US domestic Trusts and even more sophisticated, through the use of Foreign Trusts established in a foreign jurisdiction offering a special asset protection legislation such as the Cook Islands for instance. Nevertheless, in order to benefit from a strong asset protection at the moment of the event, certain conditions must be met. In addition, the tax treatment as well as the reporting requirements of Foreign Trusts have been strongly regulated by the specific set of regulations enacted by the administration Clinton in 1996. This Essay will draw the lines in between the different Trust types and go deeper into the effectiveness and possible pitfalls whenever US settlors plan to establish a Foreign Trust and appoint US beneficiaries.

1. Introduction

It used to be the common sense for many people, that an offshore Trust was a vague legal tool that lied steeped in notions of secrecy and was designed only for sophisticated and wealthy high net worth individuals who desired tax avoidance and absolute protection from creditors. Such Trusts were commonly believed to be invulnerable and absolutely undetectable to the IRS, which is, however, nowadays, far from the truth.[1] Since August 20th, 1996, when President Clinton signed into law a set of rules modifying the US taxation and reporting requirements on offshore Trusts, the handling as well as the perception of these vehicles, have changed completely.[2]

This Essay will in the first part draw the lines in between the different Trust types discussing the parameters and the differences between a US domestic Trust and a foreign Trust. In this context, the Court test as well as the Control Test will be discussed in detail. In addition, the different tax consequences between a foreign Grantor Trust and a foreign Non-Grantor Trust for US settlors and US beneficiaries will be considered.

In the second part of the Essay, the effectiveness and possible pitfalls of foreign Trusts for US settlors, US beneficiaries and foreign Trustees will be discussed. One of the main reasons to establish a foreign Trust is to benefit from a specifc foreign asset protection legsislation, such as the so called "firewall legislation" offered by the Cook Islands and further foreign jurisdictions. The Essay will go into detail and explain what is necessary to obtain an efficient asset protection through the vehicle of a foreign Trust. Concluding, the possible pitfalls and drawbacks to consider when establishing a foreign Trust and appointing US beneficiaries will be analysed. In that context, issues regarding the handling of Distributable Net Income (DNI); loans to US beneficiaries; the throwback regime for the accumulation of income; the special tax regimes regarding Controlled Foreign Corporations (CFC) and Passive Foreign Investment Companies (PFIC) will be discussed.

Last but not least, the Essay will go into the various reporting requirements for US beneficiaries, US settlors and foreign Trustees. They are deemed to be a heavy administrative burden, whereby non-compliance is sentenced with harsh penalties.

2. Offshore Trusts

A Trust is a widely recognized estate planning tool used in almost every common law jurisdiction, gaining recently in popularity.When a Trust is established, the Trustee receives the legal title to the property and thus full and absolute ownership, but without a beneficial interest, i.e. without any personal gain or profit. The Trust Fund remains separate from the Trustee's personal assets. The beneficiary on the other hand holds what is designated as the equitable title (also known as beneficial title), which is the right to profit or benefit from the property. This separation of legal- and beneficial title can occur in such way that the settlor (=grantor) retains explicitly the right to revoke the structure and thus keeps to a certain extent control over the asset, or in such way that the conveyance to the Trust is

[1] See *Zimmermann/Egger*, Offshore Asset Protection Trusts, 2J. Pract. Est. Plan. 2000-2001

[2] See *International Tax Review*, Foreign trusts under pressure, 7 Int'l Tax Rev. 34 1996

absolute and irrevocable. The latter form of course will benefit much more from an asset protection point of view, as will be elaborated later in this Essay.[3] [4]

When it comes to the definition of an offshore Trust, which is synomous to a foreign Trust, then the Regulations define what a US domestic Trust is, i.e. a Trust that meets *both*, the *Court Test* (if a US court within the United States is able to exercise primary supervision over the administration of the Trust) as well as the *Control Test* (when one or more US persons have the authority to control all substantial decisions of the Trust) and say that a foreign Trust means any Trust other than a domestic one.[5]

3. US Domestic Trust vs. Foreign Trust

Basically, the first important differentiation to make and draw the line in between the different Trust types is whether the Trust is a US domestic Trust or a foreign Trust. Within both of those categories the theory then splits into two subcategories, namely the Grantor Trust and the Non-Grantor Trust. From a US perspective, there are different tax obligations and reporting requirements of the Trust and its beneficiaries, depending on whether the Trust established is foreign, domestic, grantor or non-grantor.

In order for a Trust to be a US domestic Trust, the Trust must meet *both* of the following tests. Should the Trust not meet both tests, it will "e contrario" be qualified as a foreign Trust.

3.1 Court Test

The test is met when any federal, state, or local court wthin the US is able to exercise primary supervision over the administration of the Trust, i.e. has the authoriy under local law to render orders or judgements.[6]

In view of detailing the above, there are four so-called *"bright-lines rules"* for meeting the U.S. court test:

1. A Trust will automatically meet the court test if the Trust is registered with a U.S. court.

2. In the case of a testamentary Trust created pursuant to a will probated within the U.S. (other than ancillary probate), the Trust will meet the court test if all fiduciaries of the Trust have been qualified as Trustees of the Trust by a court within the U.S.

3. For inter vivos Trusts, if the fiduciaries and/or beneficiaries take steps with a court within the U.S. that cause the administration of the Trust to be subject to the primary supervision of such U.S. court, the Trust will meet the court test.

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[3] See *Brown/Myers* in "Administration of Wills, Trusts and Estates" (Fourth Edition) 2009, p. 215

[4] See *Hermann*, Asset Protection Trusts, Dissertation Universität Heidelberg (2001), p. 45

[5] See *Zimmermann/Egger*, Offshore Asset Protection Trusts, 2J. Pract. Est. Plan. 2000-2001

[6] Treasury Regulations 301.7701-7(a)(1)(i)

4. If a Trust document specifies that a foreign country's law will govern the Trust, this does not necessarily mean that the Trust will fail the court test. If the Trust specifies that the law of a foreign country governs, but gives a court within the U.S. the authority to exercise primary supervision over enforcing that law, the court test will be met.

In addition to the bright-line rules there is also a *safe harbor rule*, which provides that a Trust will be a U.S. Trust where the Trust instrument does not direct the Trust to be administered outside the U.S., the Trust is administered exclusively in the U.S., and the Trust is not subject to an automatic migration provision.[7]

3.2 Control Test

The test is met when one or more US persons have the authority, either by vote or otherwise, to control all *"substantial decisions"* of the Trust with no other person having veto power, except for the grantor or beneficiary acting in a fiduciary capacity.[8]

Substantial decisions mean all decisions, other than ministerial decisions, that any person is authorized to make under the terms of the Trust instrument or applicable law, including but not limited to:[9]

- Whether and when to distribute income or corpus;
- The amount of any distribution;
- The selection of a beneficiary;
- Whether to allocate receipts to income or principal;
- Whether to terminate the Trust;
- Whether to compromise, arbitrate or abandon claims of the Trust;
- Whether to sue on behalf of the trust or to defend suits against the Trust;
- Whether to remove, add or replace a Trustee; and
- Investment decisions.

4. Foreign Grantor Trust vs. Foreign Non-Grantor Trust

Being able now to differentiate a foreign Trust from a US domestic Trust, now it is important to draw the line between the foreign Grantor Trust and the foreign Non-Grantor Trust. This is important whenever there are US beneficiaries involved since there are significant differences when it comes to income tax and reporting obligations. Should the Trust qualify as a foreign Grantor Trust, all the income will be attributable to the Grantor. Similarly, gifts from the foreign Grantor Trust to a US beneficiary should be deemed as a tax-free gift from a Trust perspective. The US beneficiary himself might have reporting requirements relating to the gift. On the other hand, any Trust that is not a foreign Grantor Trust will be considered to be a foreign Non-Grantor Trust and as such will be viewed from a tax perspective as a nonresident alien individual who is not present in the US at any time for tax purposes. If

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[7] See *Gavart/Todryk/Kiracote*, Beware of the Foreign Trust Tax Trap, 24 Prob. & Prob. 40 2010

[8] Treasury Regulations 301.7701-7(a)(1)(ii)

[9] See *Gavart/Todryk/Kiracote*, Beware of the Foreign Trust Tax Trap, 24 Prob. & Prob. 40 2010

this is the case, then a foreign Non-Grantor Trust, for tax purposes, will only be taxed on US source income.[10]

A Trust will be a foreign Grantor Trust if *either* of the following conditions are met:

- the Grantor reserves the right to revoke and said power is exercisable solely by the Grantor, without approval or consent of any other person;[11]

- the amounts of income and principal of the Trust are only distributable to the Grantor or the Grantor's spouse;[12]

5. Effectiveness of a Foreign Trusts in the US

5.1 Asset Protection with a Foreign Trust

When it comes to asset protection and wealth preservation, it goes beyond frivolous lawsuits and divorce issues. Assets can be at risk from many areas: A downturn in the housing market, devalued currency, poor economic conditions, trade sanctions, governments intervention, capricious legislative bodies, foreign markets, a downturn in stock markets, interest rates and real estate, just to name a few.

In order to achieve an efficient protection of assets using a foreign Trust, it is very important that the grantor gives up both, *ownership* as well as *control* over the Trust assets. This is achieved with an irrevocable Trust which is made under circumstances that cannot be considered later as a fraudulent conveyance. It is crucial to plan ahead since the fraudulent transfer laws, for planning which occurs too late, i.e. too close in time to the happening of a potentially negative event, can consider the transfer as fraudulent and disregard the asset protection benefit.[13][14]

In order to obtain an efficient asset protection through the vehicle of a foreign Trust, the following criteria is crucial: a) the grantor cannot retain any power to revoke, rescind, or amend the Trust. The Trust must explicitly state that it cannot be rescinded, amended, or revoked by the Grantor; b) the grantor can't retain any rights, either directly or indirectly to reclaim property once transferred to the Trust. All conveyances to the Trust must be absolute and unconditional, with no strings attached; c) the grantor can't assert any authority on how assets will be managed or invested, or whether Trust property should be sold or retained. These decisions must be delegated exclusively to the Trustees; d) the grantor can't assert any authority over income generated from the Trust property or how the income shall be distributed, except as initially provided in the Trust; e) the grantor can't serve as Trustee or appoint anyone as Trustee who is not considered arms length. The courts can closely examine the

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[10] Internal Revenue Code, IRC 641 (b)

[11] Internal Revenue Code, IRC 672 (f)(2)(A)(i)

[12] Internal Revenue Code, IRC 672 (f)(2)(A)(ii)

[13] See *Keebler*, Asset Protection Planning to Keep Creditors and Predators at Bay, 2007

[14] See *Sterk*, Asset Protection Trusts: Trust law's race to the bottom?, 85 Cornell L. Rev. 1044

relationship between grantor and Trustee to determine whether the Trustee is merely the grantor's alter ego.[15]

The asset protection advantages of a foreign Trust will insulate assets not just from the usual commercial and civil tort claims, but also from matrimonial claims, forced heirship and even civil government actions. Foreign Trusts are established under the laws and jurisdiction of foreign countries which have more favorable asset protection and privacy measures and which typically do not enforce US judgements.[16] This advantage cuts against any future US creditor because the creditor will be faced with extensive and expensive litigation which will probably not result in an enforceable judgement. Thus, the creditor, because he or she is faced with expensive litigation, will generally discount any claim in an effort to settle.[17]

5.2 US tax treatment of a Foreign Trust

A US domestic Trust is generally subject to US income taxation and reporting on its worldwide assets and income.[18] Depending if the Trust is a Grantor or Non-Grantor Trust will then determine to whom the income will be attributable, i.e. either to the Grantor, the Trust itself or to the beneficiaries. With that said, generally, the Grantor will personally tax on all the income resulting from a US domestic Grantor Trust.

Similar to a non-US (foreign) individual, a foreign Trust is only subject to income taxation on income earned in the US. US source income includes, but is no limited to, income from an active trade or business in the US, interest paid by US residents and US corporations, dividends paid from a US corporation, personal services performed in the US, rents and royalties from property located in the US as well as the disposition of a US real property interest.[19]

A foreign Trust, hence, is only subject to US income tax on US source income and income effectively connected to an active US business in which the Trust has an ownership interest.[20] Moreover, foreign Trusts are completely exempt from the US tax on capital gains on intangible assets.[21] Thus, gains on the sale of US stocks as well as bonds and other debt instruments will ordinarily be completely exempt from US tax. This exemption, however, does not apply to holdings of US real property. Moreover, there are special exemptions from US income tax on income earned from US bank deposits and most US portfolio interest paid to foreign taxpayers and foreign Trusts.[22]

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[15] See *Lambert*, Asset Protection in a Nutshell, trustmakers.com (2007), p. 65 ff.

[16] See *Keebler*, Asset Protection Planning to Keep Creditors and Predators at Bay, 2007

[17] See *Zimmermann/Egger*, Offshore Asset Protection Trusts, 2J. Pract. ESt. Plan. 2000-2001

[18] Internal Revenue Code (IRC 641)

[19] Internal Revenue Code (IRC 861)

[20] Internal Revenue Code (IRC 641(b) and 871

[21] Internal Revenue Code 871(a)(2), expressly limited in the case of foreign trusts by Reg. 7701(a)(3), consistent with the provision of IRC 641(b) (foreign trust, for purposes of the taxation of trusts, to be treated as a nonresident alien individual who is not present in the United States at any time)

[22] Internal Revenue Code, IRC 871(h), 871(i)

However, it is noteworthy to mention, that the limited impact of the US income tax on a foreign Trust does not necessarily apply to the US beneficiaries of such a Trust, because the US beneficiaries of foreign Trusts (like US Trusts themselves) are generally subject to US income tax on their worldwide income. This includes distributions from foreign Trusts, which are taxed in much the same way as they would be if they were coming from a domestic Trust, with some added disadvantages, as will be shown later on. Although the beneficiary's income tax deferral seems at first sight to be a great tax advantage, antideferral tax regimes have to be taken into account.[23]

6. Possible pitfalls of a Foreign Trust in the US

In general, foreign Trusts do have certain drawbacks such as high costs, the risk of political change in the foreign jurisdiction as well as the risk of adverse consequences from domestic courts, such as fines, imprisonment for contempt and denial of bankruptcy discharge.[24] [25] In addition, the IRS, through its commissions and special task force groups have made tracking and examining offshore asset protection Trust a priority and more scrutinity is to be expected on these Trusts compared to the domestic ones.[26] Moreover, the US beneficiaries of a foreign irrevocable Trust are subject to special tax rules that do not apply to beneficiaries of domestic Trusts. The categories are the following; (1) distributable net income, (2) loans to beneficiaries, (3) throwback tax, (4) tax regime on CFC's; (5) tax regime on PFIC's and (6) reporting obligations.

6.1 Distributable Net Income (DNI)

As already mentioned, US beneficiaries are generally taxed on distributions of income from Trusts. In this context, the taxable income is based on the "distributable net income" of the Trust that is deemed to flow through to the beneficiary in the form of payments from the Trust. In general, capital gains are not a component of distributable net income of a Trust, with the result that the gains are taxed to the Trust and not the beneficiary.[27] Nevertheless, in the case of irrevocable foreign Trusts, capital gains are a component of distributable net income,[28] which means that US beneficiaries of a foreign Trust will likely pay tax with respect to these gains. Any such tax will be paid at ordinary income tax rates rather than at capital gain tax rates, which might be an unnecessary burden for the beneficiaries.[29]

6.2 Throwback Tax regime

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[23] See *Gavart/Todryk/Kiracote*, Beware of the Foreign Trust Tax Trap, 24 Prob. & Prob. 40 2010

[24] See *Nenno*, Planning with Domestic Asset-Protection Trusts (2005) 40 Real Property, Probate & Trust J 263

[25] See *Boxx*, Asset Protection Trusts in the United States, in: *Schurr* (Hrsg.), Handbuch des Vermögensschutzes für Liechtenstein, Österreich und die Schweiz (Wien 2015), p. 302

[26] *Russo*, Asset Protection: An Analysis of Domestic and Offshore Trust Accounts; 23 Mich. St. Int'L. Rev. 265 2014-2015

[27] Internal Revenue Code, IRC 643(a)

[28] Internal Revenue Code, IRC 643(a)(6)(C)

[29] Federal Income Taxes of Decedents, Estates, CCH Editorial Staff Publication, 23rd Edition, 2007, p. 605

Many irrevocable foreign Trusts are intended to accumulate income for the benefit of a class of beneficiaries or a particular beneficiary until that one has reached a certain age. In this context, it is important to note, that the US tax rules are structured to prevent foreign Trusts to accumulate income for the benefit of US beneficiaries in order to defer payments of income tax and thereby avoid US tax on distributions of income. Consequently, in any year in which a US beneficiary receives a distribution of income from an irrevocable foreign Trust that was earned in a prior year, the taxpayer must perform a special calculation to compute the "partial tax" (also called "throwback tax"), which is designed to recapture the tax that would have been paid if the income had been distributed on a yearly basis. As a result, an income tax deferral through the use of accumulating foreign Trusts is no longer possible.[30]

6.3 Closely held companies owned by Trusts

Particular problems arise in the case of irrevocable, foreign Trusts where the grantor has retained powers over the Trust that could make the assets subject to US estate tax at the grantor's death. The grantor, in this context may, in order to avoid the US estate tax, direct that the assets be held by an offshore corporation, whose stock is owned by the Trust. Such corporations, nevertheless, almost always qualify as "passive foreign investment companies" (PFIC)[31] and frequently as "controlled foreign corporations" (CFC).[32] Under the US tax rules designed to discourage tax deferral through the use of foreign corporations, if a US person is a beneficiary of an irrevocable foreign Trust, the Trust is disregarded and the US beneficiary is deemed to have a direct ownership interest in the corporation.[33] This would mean that a US beneficiary would have "phantom income" on which he would owe US income tax, even though the beneficiary may have only a future interest in the Trust.

6.4 Loans to beneficiaries

Particular attention must be paid to loans to US beneficiaries arriving from irrevocable foreign Trusts since they are treated as distributions and are therefore potentially subject to US income tax.[34] In addition, for purposes of this rule, loans to persons related to a US beneficiary (such as siblings, ancestors, lineal descendants and spouses) are treated as if they were made to the beneficiary.[35] As a consequence, loans to beneficaries might trigger income tax and therefore special attention must be paid to this possible pitfall.

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[30] Internal Revenue Code, IRC 667

[31] Internal Revenue Code, IRC 1297; A "passive foreign investment company" is a foreign corporation whose "passive income" for the taxable year represents seventy-five percent or more of such corporation's gross income, or whose average percentage of assets which produce "passive income" during the taxable year is fifty percent or more of such corporation's total assets.

[32] Internal Revenue Code, IRC 957; A "controlled foreign corporation" is any foreign corporation in which more than fifty percent of the total combined voting power of all classes of stock of the corporation or the total value of the stock of the corpration is owned by US shareholders.

[33] Internal Revenue Code, IRC 1298(a)(3) PFIC; 554(a) FPHC (Galligan)

[34] Internal Revenue Code, IRC 643(i)(1)

[35] Internal Revenue Code, IRC 643(i)(2)(B)

6.5 Reporting requirements

Apart from the tax consequences described above, it would be remiss not to mention some of the various reporting requirements of US beneficiaries, US grantors and the foreign Trustees themselves. Such obligations include amongst others, the IRS form 1040 where the US grantor reports the yearly Trust income and capital gains. Then, IRS form 3520 serves for the grantor to report on a yearly basis the ownership of the Trust to the IRS. IRS form 3520-A then obliges the foreign Trustee to report to the IRS the Trust income himself, apart from the "Foreign Grantor Trust Statement" and the "Foreign Grantor Trust Beneficiary Statement" he has to produce as well on a yearly basis. The particularity lies in the fact that harsh penalties are applied should the beneficiaries, the US grantors as well as the foreign Trustees miss the deadlines set by the IRS.[36]

7. Conclusion

Foreign Trusts have always been a very popular tool to achieve asset protection and preserve wealth from unforeseen negative events. They have always been a suitable option at the heart of estate planning. Nevertheless, it is important to highlight that certain conditions have to be met in order to avoid a fraudulent transfer of assets to the Trust and that control and ownership by the grantor has to be avoided properly in order to achieve the goals. Of course, the details of the court- and control test have to be implemented properly since there is the latent danger of any foreign Trust to be re-qualified to be a domestic one at the end, with of course enormous consequences for the beneficiaries and/or the grantor. Nonetheless, established properly, the foreign Trust is still a very powerful vehicle to protect assets from foreign judgements and creditor claims.

In addition and as already described, these vehicles offered before 1996 the possibility and great advantage of tax deferral and income taxation at the moment of distribution only. It is here important to stress that the set of legislation introduced in 1996 included a whole anti-deferral regime whereby the original tax advantages for US beneficiaries have been chipped away and it turns more and more difficult to promote the tax advantages of foreign Trusts. Of course, the treatment of non-US beneficiaries of a foreign Non-Grantor Trust is a totally different one. Having in mind the drawbacks described above, in particular the administrative burden which comes with harsh penalties for US grantors, US beneficiaries and foreign Trustees in the case of failure, future grantors better look for a very qualified practitioner in order to establish a foreign Trust.

Concluding, properly established foreign Trusts will continue to offer a very effective asset protection and tax advantages in particular situations and depending on the US ties of the investments and beneficiaries. They continue to be the better option in comparison to the US domestic Trusts, with the disadvantage of a higher administrative burden and hence risk of walking into one of the various pitfalls described above.

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[36] See *Morris Law Group*, Foreign Trusts With US Beneficiaries, 2014

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