# OFFSHORE TRUST PLANNING

Some fundamentals–in most respects, an offshore trust or a foreign trust (“FT”), i.e., a non-United States (“U. S.”) trust, is the same as a domestic (U. S.) Trust. That is, it has a “trustee” who holds legal title to assets transferred to the FT by the “settlor” or “grantor” (the person who set up the FT), and the trustee manages the assets for the benefit of, and makes distributions to, the “beneficiaries”. All of this is governed by a legal instrument called a “trust deed” or “trust indenture”. What makes the FT a “foreign” trust is mainly that the trustee is a foreign entity (usually a foreign trust company affiliated with a foreign bank) and, by the terms of the trust indenture, it is governed by the laws of a country other than the U. S. (usually a common law country that does not impose income taxes on its local trusts, such as Bermuda and most Caribbean island nations). This “foreign” status invokes special rules under the U. S. income and estate tax laws, as discussed next.

A FT will generally be either a “grantor trust” or a “non-grantor trust” (or “perfected trust”) for U. S. income tax purposes. A “grantor trust” is one that, by virtue of special provisions of the U. S. Internal Revenue Code (Sections 671 through 679), is essentially treated as though it does not exist, and so all of the income of the FT is attributed to the “grantor” (the person who set up the trust) or to other persons who may have transferred property to the FT. Usually, a FT is a grantor trust because the grantor retained certain powers over the FT such as the power to revoke or to substantially change the trust indenture. Also, there is a special rule that says that any time that a U. S. person sets up a FT that has U. S. beneficiaries, the FT will be a grantor trust as to that U. S. person, regardless of whether he has retained any powers over the FT.

A “non-grantor trust” is one that has escaped grantor trust status because the grantor did not retain any powers over the FT and because the U. S. grantor has died and so there is no one left to whom the FT’s income can be attributed, or because the grantor was a non-U. S. citizen/resident. Thus, for example, if one’s elderly relative were to set up a FT for one’s benefit, the FT would be a grantor trust as to that relative until he or she died, but upon his or her death, the FT would “perfect” and become a non-grantor FT. Similarly, if one were to set up a FT for the benefit of one’s children, the FT would be a grantor trust as to the creator for his or her life, but upon the creator’s death, the Ft would “perfect” and become a non-grantor FT. The U. S. income tax benefits of a non-grantor FT are discussed next.

A non-grantor FT is essentially treated like a foreign individual for U. S. income tax purposes. As a foreign person, the FT would generally not be subject to U. S. income tax on its non-U.S. source income (income earned outside of the U. S.), and there are many kinds of <u>U. S.-source income</u> that the FT could earn without paying U. S. income taxes, such as interest on bank deposits and certificates of deposit, interest on many kinds of bonds and other debt instruments, and capital gains from the sale of stock and securities. However, the FT, like all foreign persons, would still be taxable on gains from the sale of U. S. real property, rent from U.S. real property, and dividends from U. S. corporations. Rent, dividends, and other types of passive income are generally subject to a U. S. withholding tax of thirty percent (30%) of the gross amount of the payment but, with proper planning, this rate can sometimes be reduced substantially. Thus, a perfected (non-grantor) FT can accumulate investment earnings tax free if its investments are properly monitored to avoid taxable U. S. income. This applies even though the FT has U. S.

beneficiaries, although when earnings are distributed to the U. S. beneficiaries, the U. S. beneficiaries must then pay U. S. income tax on the earnings, plus an interest charge on the amount of U. S. income tax that was deferred by not distributing earnings in the same years that they were earned. To a significant degree, this interest charge can be minimized by arranging investments through underlying entities that will not distribute their earnings to the FT until the same year that distributions are ready to be made. As you might expect, all of this involves considerable and sophisticated planning, but will usually result in the total avoidance of the interest charge.

As can be discerned from the above discussion, a FT is an excellent U. S. income tax deferral device if the grantor trust rules can be avoided. As mentioned above, these rules can be avoided (that is, the FT will be a non-grantor FT) only if either the FT was established by a (i) foreign person or (ii) U. S. person who has died.

Again, if one's elderly relative were to establish a FT, either by setting one up now (an "inter vivos" FT) or by providing in his or her will that the FT will be established upon his or her death (a "testamentary" FT), a perfected (non-grantor) FT would be in place upon the death of that elderly relative. Until that person's death, however, any income earned by the FT that is otherwise subject to U. S. income tax (in other words, other than tax-exempt interest income) would be taxable to that elderly relative. Certain stop-gap measures however can be taken to insure that the elderly relative will not incur any "surprise" U. S. income taxes. The main benefits of the FT will come after the grantor's death and when the FT has acquired significant assets, possibly from sources other than the grantor, as discussed next.

Assuming that one's elderly relative had set up a FT for the benefit of his or her family and has since died, thereby perfecting the FT. Also assume that this relative could only afford to fund the FT with US$10,000.00, so that the FT had only minimal assets at the time of his or her death. In order to get any benefit from the fact that the FT is now a non-grantor FT, significant assets would have to be transferred to the FT. However, if any U. S. person were to <u>gift</u> property to the FT, the U. S. income tax rules would cause that U. S. person to be treated as a "grantor" of the FT, thereby causing such U. S. person to be subject to U. S. income tax on any income traceable (which is not always easy) to the property that the U. S. person had gifted to the FT. However, if one were to <u>sell</u> property to the FT, receiving payment that is equal in value to the assets transferred to the FT, this negative result would not obtain. Assets may be sold to the FT in return for a note from the FT. There are express provisions in the tax law governing the terms of such sales which, of course, must be scrupulously followed.

There are a number of U. S. income tax aspects to take into consideration upon such a sale to a perfected FT:

1. any gain inherent in the property that was transferred to the FT must be recognized at the time of the transfer. Thus, such transfers are generally limited to assets that have minimal inherent gain.
2. Payments have to be made on the note from the FT to the transferor (one's self), and, of course, each payment is comprised partly of an interest element which would be taxable income to the recipient for U. S. income tax purposes. Thus, to make the U. S. income tax deferral benefit of the FT worthwhile, the FT would

have to earn a significantly higher return on its investments than the rate of interest being paid on the note or the annuity. Of course, the FT is assisted by the fact that it does not have to pay U. S. income tax on its earnings. This benefit is enhanced if the note provides that payments will not begin until some time in the future (a “deferred” note).

3. The Internal Revenue Service has clearly outlined the terms of the note to be given by the FT. Among other things, those terms require a maturity date of no longer than five (5) years with no renewals and an interest rate of between one hundred percent (100%)) and one hundred and thirty percent (130%) of the applicable federal rate.

In sum, planning for U. S. income tax purposes involving FTs depends upon there being a perfected (non-grantor) FT, and the extent of the U. S. income tax deferral depends upon whether the FT is obligated under a note, or other such instrument to make payments to the U. S. transferor. Also, any such U. S. income tax planning must be coordinated with U. S. estate and gift tax planning. For example, with respect to a grantor FT, the grantor of the FT is paying the U. S. income tax on the FT’s earnings, allowing the FT to retain 100% of its earnings.
This means that the grantor is effectively transferring the amount of U. S. income tax that he is having to pay to the FT and its beneficiaries without having to pay a U. S. gift or estate tax and without having to use up his lifetime “unified credit”.

There are of course long term U. S. income tax benefits in setting up a FT now and transferring assets to it. For example, if an elderly relative set up a FT for the benefit of you and your family now, and if you were to sell slightly appreciated assets to the FT in return for a note, and if the FT were to limit its investments to capital appreciation securities, the U. S. income tax results would be as follows:

1. while the income of the FT would be attributable to the elderly relative for as long as he/she were alive, there should be little or no income attributed to him/her as long as the FT did not realize any income (capital appreciation is not realized income until the asset is sold);
2. Upon the elderly relative's death, the FT would perfect into a non-grantor FT and it could thereafter realize income, such as gain on the sale of capital appreciation securities, without paying U. S. income tax. It could thereafter reinvest its earnings free of U. S. income tax.
3. At the time that you transferred the assets to the FT in return for the note, you would recognize and pay U. S. income tax on gain inherent in those assets, but again, we are presuming that the amount of gain inherent in these assets is minimal.
4. When payments begin on the note that you had received for the assets, you would realize and pay U. S. income tax on the interest elements of each payment. Because the payments were deferred over a significant period of time, the interest element of each payment could be substantial.

The preceding is, of course, only a thumbnail sketch of FT planning, but it should be sufficient to afford a fundamental grounding in how this type of planning works and the circumstances in which it is appropriate.

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