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TAX IMPLICATIONS FOR OFFSHORE TRUSTS

INTRODUCTION

By now, you are familiar with the key concepts underscoring the need for asset protection. You know that there are many entities and structures that can be used to strengthen your defenses against creditors' attacks or, even better, reduce the likelihood of claims being raised at all. Indeed, offshore entities can provide significantly greater deterrence to creditors than their domestic counterparts. However, there is one creditor whose claim to your assets cannot be deterred and is inevitable: the Internal Revenue Service (IRS). And while you know that certain domestic asset protection entities come with tax savings or tax liabilities, you might be inclined to believe that offshore entities immunize your assets from tax consequences as effectively as they ward off creditors. After all, if your property is held in another country, you might logically think that the United States government should not tax it. Unfortunately, this assumption is wrong, and anyone who tells you otherwise is dangerously misinformed.

Understandably, the U.S. does not encourage individuals to seek offshore entities for investment or asset protection purposes. In response to those individuals who do so, the IRS and Congress have enacted laws specifically limiting the tax benefits that had formerly been available to U.S. investors or grantors of offshore trusts, and increased the reporting requirements (and penalties for failure to report).

Our aim in this article is to help you navigate the maze of these laws found within the Internal Revenue Code (IRC) in several important respects. We provide a brief overview of the more salient aspects of the U.S. income tax treatment of grantors of foreign grantor trusts ("FGTs") and foreign non grantor trusts ("FNGTs"), U.S. tax reporting requirements relating to such trusts, and possible tax saving techniques utilizing foreign trusts in general.

Bear in mind that because we are dealing with a statutory code, it is necessarily technical reading. Although this article serves as an introduction to this complex but highly dynamic area of asset protection, it assumes that a reader will have some familiarity with basic principles of asset protection, estate planning and taxation.

THE FOREIGN TRUST RULES OF INCOME TAXATION

The U.S. income tax consequences to a *grantor* (also referred to as a settlor, in foreign trusts) that establishes a trust will vary, depending on whether the trust is classified as *foreign* or *domestic*, using IRC parlance. To qualify as a foreign trust, a trust has to satisfy a two-part test. First, a U.S. Court must not be able to exercise primary supervisions over the administration of such trust. And second, one or more U.S. persons must not have the authority to control all substantial decisions¹ relating to the trust.² (The Regulations² provide additional guidance in making the determination of the *situs*, or legal location, of a trust, but they are beyond the scope of this article.)

Once a trust is classified as a foreign trust using the above test, the taxation of the income of such a trust involves a further determination as to whether it is a *grantor* trust (FGT) or a *nongrantor* trust (FNGT). An FNGT is one in which a U.S. person,³ as grantor or settlor of the trust, has **not** retained powers causing him to be treated as the owner of the trust for income tax purposes. To the extent that taxes are owed, the trust - not the grantor - pays. The grantor of an FNGT will not be treated as the owner of the trust if the trust is (1) irrevocable, (2) has no U.S. beneficiaries during the grantor's and grantor's spouse's lives, and (3) U.S. persons cannot receive distributions until one taxable year after the death of the grantor and grantor's spouse. Conversely, a grantor trust is a trust in which the grantor is treated as the owner, and therefore the taxpayer, for the purposes of all income, deductions and credits of the trust.⁴

Put simply, the foreign grantor trust becomes a kind of flow-through entity for income tax purposes resulting in all tax-paying liability being placed squarely on the grantor.

The grantor trust rules found in IRC Sections 671 through 679, address whether the grantor or the trust is responsible for the income tax on trust income. The rules are applicable only to income tax and not to gift or estate tax⁵. These rules affect not only U.S. citizens but also U.S. residents and nonresidents. Certain prerequisites, if met, trigger the application of the grantor trust rules. The general rule is that any time the grantor retains substantial dominion and control over the trust, the burden of the tax on the trust's income remains with the grantor. In particular, the existence of the following circumstances results in continued income taxation of the grantor:

1. A reversionary interest⁶ in trust income or corpus, unless the interest is less than 5% of the value of that portion of the trust, in which the Grantor has the reversionary interest (in which case the interest will be ignored);
2. The power to control beneficial enjoyment of the corpus or income of the trust;
3. Certain powers of administration, like the power to control the investment of the trust funds, which, if exercised, would primarily benefit the grantor and not the beneficiaries;
4. The power to revoke the trust; or
5. The power to accumulate or distribute income for grantor's benefit or for the benefit of the grantors spouse.

Notwithstanding the above rules, if a U.S. person directly or indirectly transfers property to a foreign trust, which at any time during the transferor's taxable year has a U.S. beneficiary, such person, as transferor, will be deemed the owner of the portion of the trust attributable to that property, and will pay the gift tax on the transfer. This catchall provision was added by Congress to combat the widespread tax avoidance resulting from perceived abuses in foreign trust planning. While the aim of this provision was seemingly straightforward -to prevent the use of foreign trusts for tax-free accumulation of income - the rules of this provision are extremely complex and far-reaching, and cannot be fully addressed in this article.

There are, however, several non-obvious points worth mentioning with respect to the scope of the above provision. First, for the purposes of determining the applicability of the provision, a foreign person who transfers property to a foreign trust and becomes a U.S. citizen within five years of the transfer, will be treated as a U.S. transferor with respect to that portion of the trust property that, as of the date of immigration, is attributable to the prior transfer. And second, a trust will be treated as having a U.S. beneficiary for any given taxable year unless (1) under the terms of the trust, no part of the income or principal of the trust can be paid or accumulated during that taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated at any time during such taxable year, no part of the income or principal of the trust could be paid to or for the benefit of a U.S. person.

If additional significance in the grantor trust rules is the issue of grantor's residency status. Specifically, United States citizens and residents are taxable on their worldwide income. Thus a U.S. citizen or resident grantor would be taxed on the income arising from the property transferred to a grantor trust. In contrast, grantors who are neither citizens nor residents of the U.S. are typically taxed only on their U.S.-sourced fixed or determinable income, or income that is effectively connected with a U.S. trade or business.

While the rules of foreign trust taxation are many and full of twists and turns, **the one principle that should be extracted from this discussion is that there are no material income tax benefits for a U.S. person who transfers property to a foreign trust!** With that being said, however, there are other tax benefits that could be achieved with a foreign trust. (You will find the discussion in Section D informative on that point.)

REPORTING AND DISCLOSURE REQUIREMENTS

There are substantial reporting requirements imposed on foreign trusts and grantor trusts in particular. Some, but not all, of these formal requirements are described below. There may be other ancillary forms and reports that must be filed given the complexity of the offshore structure and the various transactions carried out using such structure. However, the forms that are listed below comprise the essential foreign trust tax reporting requirements of the three key participants in the trust scenario: the grantor/settlor, the trustee, and the beneficiaries.

1. GRANTOR/SETTLOR

- a. **Form 3520** - Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Any U.S. person, who creates a foreign trustor, alternatively, makes transfers to a foreign trust, must file the above form. As its title suggests, this form is filed annually, along with the grantor's income tax return. There is a penalty of 35% of the transferred amount imposed for failure to file, as well as possible criminal penalties.
- b. **Form 3520-A** - Annual Information Return of Foreign Trust with a U.S. Owner. Technically speaking, the trustee of an FGT has an obligation to file this form. **However, the penalty for failure to file this form is imposed on the grantor!** The penalty amount is equal to 5% of trust assets that the U.S. grantor is considered to own. Thus, any U.S. person who becomes liable for tax under any of the grantor trust rules discussed in the previous section must ensure that the trustee files Form 3520-A.
- c. **Form 90-22.1** - Report of Foreign Bank and Financial Accounts. This form mandates disclosure when a U.S. citizen has custody, control, or signature power over a foreign bank account.
- d. **Form 4790** - Report of International Transportation of Currency or Monetary Instruments. This form must be filed by **any person** who physically transfers, mails, or ships cash or bearer securities having a value of \$10,000 or more in or out of the United States.

2. TRUSTEE

- a. **Form 3520-A**. (See above)
- b. **Form 1041** - U.S. Income Tax Return For Estates and Trusts. The trustee of an FGT must file a statement attached to Form 1041 to report the income of the trust.

3. BENEFICIARIES

Form 3520. Any U.S. beneficiary who receives distributions from an FGT during the taxable year must file this form as well.

TAX MINIMIZATION

The notion of a foreign trust is frequently associated with the idea of tax savings. While this may have been true to some extent, over the years Congress has done a lot to close many, if not most, of the opportunities. In fact, as a general rule, foreign asset protection trusts (FAPTs) are now structured to be income tax neutral, meaning that there are no inherent income tax benefits to having an FAPT. As a result, the grantor will typically pay the tax on income earned by the trust, and the trust assets will be includable in the grantor's estate after his death. This result can be avoided by utilizing an FNGT, but there is a trade-off requirement that the grantor must give up any control over the assets transferred into such a trust (see discussion in section B). Additionally, there could be a substantial gift tax liability, depending on the amount and character of the transfer. Nevertheless, some other planning opportunities to minimize taxes remain.

1. VARIABLE LIFE INSURANCE

A foreign trust, particularly an FNGT, can be used to purchase offshore variable life insurance policies. Where the trust becomes the policy owner, the benefits of such an acquisition are many.

Offshore variable life insurance enjoys much greater regulatory flexibility than its domestic counterpart, since it is not subject to U.S. regulation. As a result, it can be closely tailored to the planning needs of differently situated clients. Moreover, the administration costs of an offshore policy tend to be lower, given the lower overhead costs enjoyed by many offshore insurance carriers. There is no state premium tax if the policy is purchased by an offshore trust. From an asset protection perspective, there are additional safeguards provided by the structure of an offshore variable life insurance policy, as well as stricter confidentiality laws in offshore jurisdictions.

From a tax-savings perspective, there are also numerous advantages. Investment income generated by the offshore policy is not taxed to the offshore trust (policy owner) during the life of the insured. If structured properly, insurance proceeds will pass income and estate tax free at the death of the insured. Finally, certain variable life insurance policies permit borrowing without negative income tax implications.

2. PRIVATE ANNUITY

While the idea of using a private annuity in offshore asset protection planning is widely accepted, until recently, private annuities have typically been used primarily in conjunction with variable life insurance policies. The practice has been to invest some of the premium payments in one or more offshore entities, such as an International Business Company (commonly referred to as "IBC"), which in turn would purchase appreciated assets from a U.S. person (the insured under the policy) in exchange for a private annuity arrangement. The principal advantages of this arrangement are (1) the prorating of the capital gains taxes over the period of the transferor's life expectancy, (2) exclusion of the value of the unpaid portion of the annuity from the transferor's estate, and (3) absence of U.S. income taxation on sales of the appreciated property by the offshore entity.

Recently, however, some practitioners have suggested combining the private annuity with an FNGT. While this structure achieves much of the same tax efficiency as the private annuity-variable life insurance arrangement, it also provides added asset protection and much greater flexibility as to the disposition of the accumulated earning by employing the trust mechanism. It is important to note, however, that the private annuity - FNGT model carries with it greater tax risks. Specifically, given the annuity element, the IRS might re-characterize the trust as a grantor trust (FGT) with ensuing adverse tax consequences and additional reporting requirements.

3. CHARITABLE TRUSTS

It is no secret that the IRS encourages gifts to charity by rewarding taxpayers who make gifts with tax deductions. In situations where a U.S. citizen wants to make a substantial contribution to charity while continuing to enjoy some of the benefits of the contributed property, a *foreign grantor charitable trust* can be used. The charitable trust solution is particularly useful in cases where there are significantly appreciated capital assets.

The IRC recognizes two types of charitable trusts: Charitable Remainder Trusts and Charitable Lead Trusts. With a Charitable Remainder Trust, the grantor transfers property to the trustee, which the Trustee in turn sells without facing any capital gains tax due to the trust's charitable status. Following the sale, the trustee reinvests the proceeds into a high-income investment. The grantor can then enjoy the income generated by the investment in the form of an annuity (fixed annual payment for the term of the trust) or a unitrust (fixed percentage of income for its term). There are, however, potential gift and estate tax implications when the trust is established; for example, recipients of annuity or unitrust payments are taxed on the income.

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In contrast, the Charitable Lead Trust first pays income to designated charities for a period of time and then pays the remainder to its beneficiaries (often family members). Similar to the Charitable Remainder Trust, the Charitable Lead Trust must be irrevocable and can be structured to pay out either as a unitrust or an annuity. But unlike the Charitable Remainder Trust, the Charitable Lead Trust is not tax exempt and cannot defer tax on gains. The Charitable Lead Trust does, however, provide estate tax advantages, which are achieved by virtue of valuation discounts that the grantor receives on that portion of the trust, which passes to his beneficiaries.

CONCLUSION

Foreign trust planning is an important and effective component of asset protection. But while utilization of a foreign trust structure achieves added protection from creditors and provides flexible distribution controls, it generally does not yield any income tax benefits. Moreover, by creating a foreign trust, the grantor becomes subject to a complicated tax-reporting regime, the costs of compliance with which might outweigh some of the benefits of the trust. Nevertheless, with proper planning, a foreign trust could accomplish many of your estate planning and asset protection goals. Depending on your asset composition and risk tolerance, a foreign trust could be structured in such a way as to reduce your domestic tax liability for capital gains and estate taxes. However, we recommend that you consult an experienced professional to gain a greater understanding of the costs and risks involved.

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