

Foreign trusts in America



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Several American states, including Alaska, Delaware, Nevada, South Dakota and Wyoming, have been changing their trust laws to compete with offshore jurisdictions. They have been eliminating state taxes on trusts, lengthening the permissible duration of trusts, and strengthening asset protection. These changes, along with changes to the definition of a foreign trust for tax purposes, have been enabling these states to compete with offshore jurisdictions.

REGULATORY CHANGES ALLOW FOREIGN TRUSTS TO MASQUERADE AS AMERICAN

In 1999, US Treasury Regulations went into effect that changed the definition of a foreign trust for US tax purposes. These changes allow trusts to be structured as foreign for US tax purposes with so little connection to a foreign jurisdiction that most people would think that they are as American as apple pie.

The US Internal Revenue Code defines a foreign trust as any trust other than a domestic trust. Under the Treasury Regulations, a trust is domestic for US tax purposes if it meets both a “court test” and a “control test”.

The “court test” looks to whether or not a court within the US is able to exercise primary supervision over the administration of the trust.

The “control test” looks to whether one or more US persons have the authority to control all of the substantial decisions of the trust. The Treasury Regulations list several types of substantial decision-making powers.

Trust planning for multinational families has traditionally been conducted in offshore jurisdictions. Pressure from the US government is causing advisors to forgo using offshore jurisdictions and is stifling free trade in trust services

It is not hard to structure a trust so that it will be classified as foreign under the Treasury Regulations. All it takes is giving a nonresident a single substantial decision-making power. For example, a trust is foreign if it has a non-resident protector who can replace the trustee. Thus, a trust can have Delaware law as its proper law and be administered by a financial institution in Delaware and still be classified as foreign.

THE US GOVERNMENT DISTRUSTS ANYTHING UN-AMERICAN

Advisers have increasing reason to make foreign trusts seem as American as possible, even though they are structured to be foreign for tax purposes.

*“A trust is foreign
if it has a non-resident protector
who can replace the trustee”*

The US Internal Revenue Service has been cracking down on abuses involving offshore trusts. In recent years, there have been well-publicised prosecutions of tax evaders who have hidden income in offshore trusts.

It is right to crack down on abuses. However, most IRS agents who audit tax returns are likely to be suspicious of anything involving an offshore jurisdiction and have little understanding of how foreign trusts are used for legitimate tax planning.

The title of a recent US Senate subcommittee report exemplifies current government attitudes: ‘Tax Haven Abuses: The Enablers, the Tools and

Secrecy'. The report condemns offshore jurisdictions for harbouring tax evasion, financial fraud, and money laundering. It says little about:

- the cooperation of offshore jurisdictions with the US to prevent abuses;
- the concerns of US law enforcement about similar abuses in the US;
- the cross-border tax scams involving onshore jurisdictions that have tax treaties with the US;
- the legitimate uses of foreign trusts and offshore jurisdictions;

The report received widespread news coverage and was followed closely by advisers in the US. Although many advisers might not agree with the report, it may still cause them to reconsider what jurisdictions to use for foreign trust planning.

26 LEGITIMATE TRUST PLANNING HAS TRADITIONALLY BEEN DONE IN OFFSHORE JURISDICTIONS

Offshore jurisdictions traditionally have been used in trust planning for multinational families. The tax consequences of trust planning often turn on whether a trust is domestic or foreign. A foreign jurisdiction used to be essential in creating a foreign trust.

“Free trade should be
as much a part of the American way
as liberty and democracy”

A foreign non-grantor trust is taxed in the same manner as a non-resident alien individual. It is therefore usually possible to structure an investment portfolio with non-US assets so that the trust owes no US tax. A domestic nongrantor trust however is subject to US tax regardless of how it structures its investment portfolio.

Distributions of accumulated income to nonresident beneficiaries from a foreign non-grantor trust are not subject to US tax.

Distributions of accumulated income to US beneficiaries from a foreign nongrantor trusts are sub-

ject to tax and a punitive interest charge.

Thus, planning for multinational families often involves dividing assets between domestic trusts for US residents and foreign trusts for non-residents. Foreign trust planning that traditionally has been carried out in offshore jurisdictions is now being done in the US.

STIFLING FREE TRADE IN TRUST SERVICES

Despite the legitimate uses of offshore trusts, US government attitudes about offshore jurisdictions are stifling free trade in trust services. It is a sign of the times that one of the largest banks in the offshore trust business recently acquired a trust company in Delaware.

Advisers are increasingly choosing to use trust jurisdictions in the US. They are probably not making this choice based on the quality of trust services. There is little experience in administering foreign trusts in the US.

Experience in administering a foreign trust is crucial. Complex US tax and reporting rules make mistakes costly. It is likely that advisers choosing US jurisdictions are reacting to US government attitudes about offshore jurisdictions.

It is unfortunate that these attitudes are stifling free trade. Free trade should be as much a part of the American way as liberty and democracy.

LEVELLING THE PLAYING FIELD

More should be done to promote free trade in trust administration services than than adjusting US government attitudes toward offshore jurisdictions. Ironically, a foreign trust can be administered in the US, but a domestic trust cannot be administered in a foreign jurisdiction. It would be quite simple to amend the US Internal Revenue Code to allow foreign jurisdictions to administer domestic trusts. Doing so would promote free trade in trust services. It would also send a public message, which might counterbalance the current message emanating from the US government about offshore jurisdictions. ■