KEY POINTS

What is the issue?

Foreign non-grantor trusts (FNGTs) have long been misunderstood.

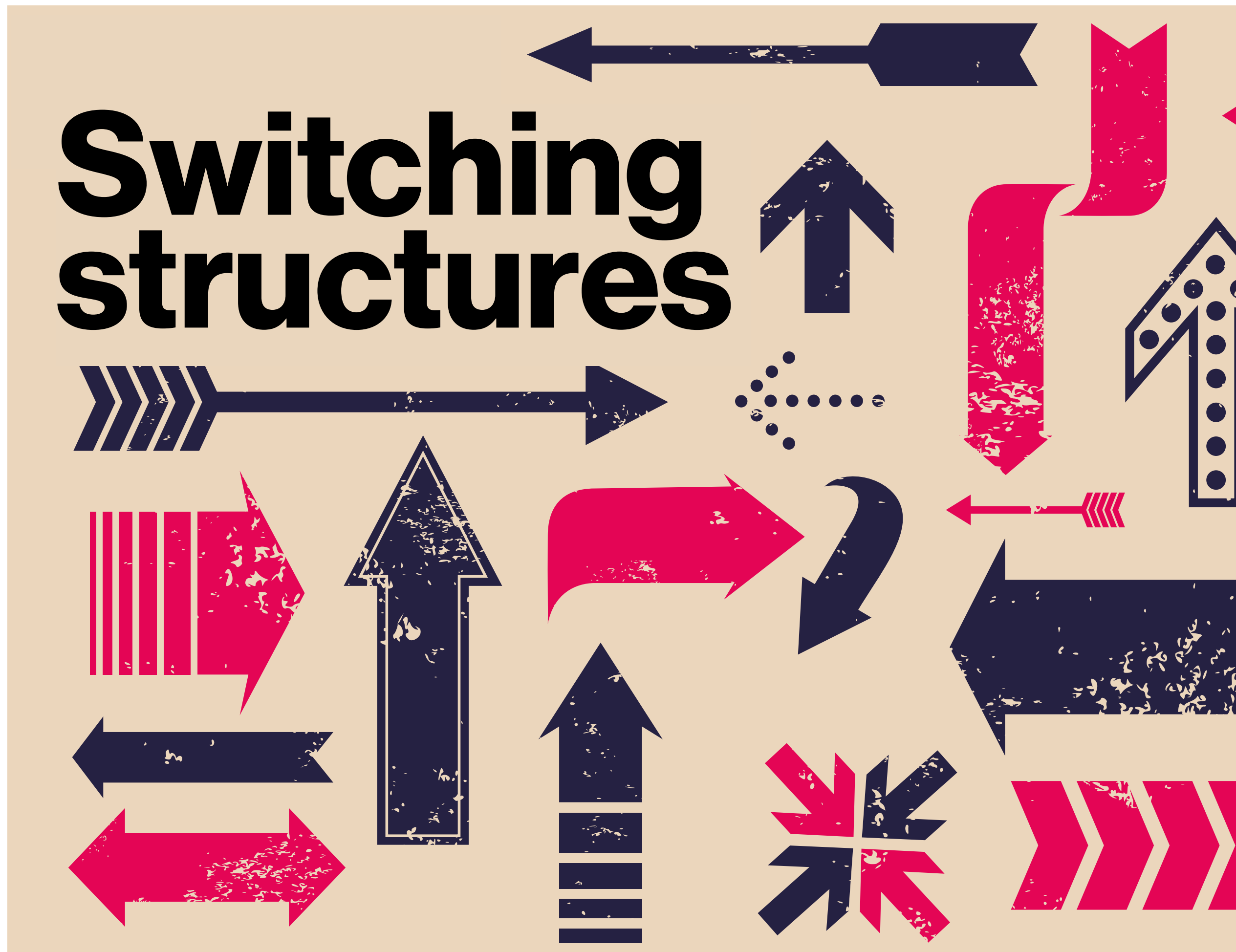
What does it mean for me?

It is worth revisiting many advisors' preconceived notions of FNGTs, especially in a rising tax environment where US beneficiaries do not require the funds imminently.

What can I take away?

Compounded tax saving (when combined with active gain harvesting) tends to overcome the hurdles to accessing tax-efficient offshore wealth.

Switching structures



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SHELLY MEEROVITCH AND JOHN McLAUGHLIN DISCUSS HOW US BENEFICIARIES OF FOREIGN NON-GRANTOR TRUSTS CAN EFFICIENTLY ACCESS GREATER WEALTH OFFSHORE

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Wealth intended for US beneficiaries often lands in the US because advisors underestimate the cumulative tax drag while incorrectly assuming tax-efficient access becomes unattainable once wealth accumulates offshore.

In this article, the authors demonstrate that in an increasing tax environment where US beneficiaries do not require immediate access to funds:

- the economic benefit of compounded tax savings that a foreign non-grantor trust (FNGT) offers becomes more compelling; and
- active gain harvesting strategies can place tax-efficient access to offshore wealth within reach.

TAXATION OF US BENEFICIARIES OF TRUSTS

To the extent it has taxable income, a US non-grantor trust (NGT) is a US taxpayer subject to US income taxes. Suppose an NGT distributes part, or all, of its distributable net income (DNI) to US beneficiaries. In that case, the trust receives a distribution deduction and the beneficiaries are taxed on the income instead. Realised long-term capital gains and qualified dividends are taxed at lower rates currently afforded in the US.[1] If distributions exceed the NGT's current income, the excess is treated as a non-taxable distribution of principal. In either case, all income is subject to US income tax when it is earned, either to the NGT or to its US beneficiaries.

An FNGT is not a US taxpayer.[2] Therefore, the US cannot 'tax' its income until it is distributed to a US beneficiary.[3] When such a distribution consists solely of DNI,[4] its US tax treatment resembles that of an income distribution from a US trust. However, if the FNGT has undistributed net income (UNI),[5] the US cannot tax it while it remains in the FNGT, assuming the FNGT owns no passive foreign investment companies or controlled foreign corporations. To discourage such accumulation (and the resulting tax deferral), the US treats distributions of UNI to US beneficiaries (when a distribution exceeds the FNGT's DNI) as an accumulation distribution and subjects them to a penalising 'throwback tax' and an interest charge.[6] The longer the accumulation period and deferral of US tax, the higher the penalty.

This heavy taxation of UNI predisposes advisors and US beneficiaries to favour US structures over offshore ones. However, this bias subjects the current growth of family wealth to tax drag; all to ensure unfettered future access to tax-efficient wealth, even when beneficiaries will not need the funds in the US for decades to come.

There are two flaws to this approach, both of which become increasingly detrimental over time. First, advisors typically underestimate tax drag's adverse impact: damage that compounds as tax rates rise. Second, advisors mistakenly assume that significant wealth cannot be accessed without costly UNI distributions.

TIMING IS EVERYTHING

The following illustration demonstrates the material impact tax drag can ultimately impose on wealth. Consider a European high-net-worth family: Albert, the 40-year-old grandson, lives in Luxembourg with his wife and three children; all are US citizens. His maternal grandfather, a non-US citizen, wishes to fund an irrevocable trust with USD100 million to benefit Albert and his descendants.

Given that all intended beneficiaries are US citizens, the family's advisors recommend transferring the USD100 million to an NGT.

'When access is not required for some time, FNGTs allow US beneficiaries to experience tax-free growth and tax-efficient access to greater accumulated wealth'

Regrettably, this advice focuses solely on the beneficiaries' tax status without considering their financial needs. Not only is Albert a wealthy entrepreneur in his own right, but he also stands to inherit significant wealth from his father's side. He will likely leave the funds from his grandfather's trust untouched, while his children or even grandchildren have a greater propensity to require access (though not until the distant future).

If Albert's grandfather funds an NGT with USD100 million in a state that does not impose state income taxes, it will grow to USD890 million over 40 years. Yet the same amount will grow to USD1.5 billion in an FNGT.[7] Foregoing 40 years of US income taxes under current rates results in almost USD607 million added to the family's fortune. Meanwhile, in a rising income tax environment,[8] that difference could reach as much as USD932 million (assuming the NGT would be worth USD565 million after 40 years), representing more than 165 per cent of additional wealth.

Such a drastic increase seems unquestionably persuasive; however, because it accumulates in an FNGT, the wealth primarily consists of UNI. As such, the trust's US beneficiaries cannot readily access it, at least not as easily as the more modest NGT funds. However, unless the US beneficiaries need immediate access to most or all of the wealth, they may ultimately prove far better off with an FNGT.

ALL THINGS COME TO THOSE WHO WAIT

With an effective investment strategy and adept tax management, significant portions of the wealth accumulated offshore can be successfully and efficiently transferred to US beneficiaries, leaving UNI untouched.

Recall Albert's trust. Assume that it is structured as an FNGT with USD1.5 billion after 40 years of tax-free growth. Albert's descendants, all US citizens, need to procure funds that exceed the FNGT's DNI. Remember, if the trust had been created in the US, the beneficiaries would have enjoyed tax-efficient access to USD890 million.

To give Albert's descendants an equivalent amount of latitude, the FNGT's trustee could begin distributing all DNI to an NGT. Doing so for 20 years will transfer more of their fortune onshore relative to a scenario where only an NGT is established for Albert from the start while still leaving USD1.8 billion in the FNGT,[9] resulting in over 68 per cent more family wealth.

Cumulative DNI distributions can be a powerful tool to move family wealth onshore. Over a 50-year period, over 90 per cent of offshore family wealth can be transitioned to the US through DNI distributions. However, if 20 or 50 years is too long for the beneficiaries to wait, the FNGT's trustee could speed up the process by generating more DNI through selective gain harvesting. For instance, in as little as 12 years, aggressive gain harvesting or the build-up and realisation of gain in the first year and the annual realisation of all gains thereafter[10] could create as much wealth in the US as there would have been if an NGT had been implemented since inception. This could be accomplished while still leaving over USD900 million in the FNGT, resulting in 54 per cent more wealth in the NGT and FNGT combined. In a higher tax environment, transferring funds onshore would take just seven years and result in 122 per cent more wealth for the family overall.

CONCLUSION

When funds from non-US sources are needed in the near term to benefit US taxpayers, a US structure may be most appropriate. However, when access is not required for some time, FNGTs allow US beneficiaries to experience tax-free growth and tax-efficient access to greater accumulated wealth. Assembling an adept professional team to properly implement the strategies described herein remains critical for success.

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1 Current US tax rate assumptions: 23.8 per cent tax for capital gains and dividends (assumed to be qualified); unless otherwise noted, we assume this rate to apply for NGTs. **2** In this article, we assume no tax is paid by FNGTs in the form of US withholding. **3** See §652(a), §662(a) of the *Internal Revenue Code of 1986* (the Code), as amended, and the regulations thereunder, unless otherwise specified. **4** §643(a), the Code **5** §665(a) and (b), the Code **6** §668, the Code **7** Assumes a 7 per cent total return including 2 per cent dividends and a 5 per cent appreciation for FNGT and NGT assets. Unless otherwise noted, we assume 'conventional management' with 20 per cent annual turnover. **8** Higher US tax rate assumptions: 43.4 per cent tax for capital gains and dividends. **9** Measured relative to the scenario where only an NGT is established. **10** Aggressive gain harvesting assumes 100 per cent annual turnover (all long term). For the foreign trust with 'aggressive gain harvesting', we assume the trustee builds up embedded capital gains to 40 per cent (versus 15 per cent for the baseline scenario) prior to making distributions in the 41st year. Assumes 'conventional management' and no distributions from the NGT in all scenarios.