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It's About Time—When Offshore Trusts for U.S. Beneficiaries Make Sense

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When the use of a foreign grantor trust is not possible,[1] conventional wisdom dictates that a U.S. trust structure should be employed for gifts from foreign grantors to U.S. beneficiaries. Moreover, when all of the beneficiaries of a foreign non-grantor trust (FNGT) are U.S. taxpayers, the FNGT should either be moved onshore or — if that is not feasible — all of the FNGT's income should be distributed to a U.S. trust.

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[1] The authors addressed the utility and taxation of foreign grantor trusts in their prior Bloomberg Industry Group article. *See* Meerovitch, McLaughlin, and Gallagher, *Shifting Gears, Planning for the Death of a Foreign Grantor*, 43 Tax Mgmt. Est., Gifts & Tr. J. No. 4 (July 12, 2018). This article focuses solely on foreign non-grantor trusts.

These approaches are generally considered the paths of least resistance due to the complexity, added compliance, and associated costs of properly administering an FNGT with U.S. beneficiaries. Without proper supervision and foresight, inappropriate investments abound and erroneous distribution decisions (or lack thereof) often result in prohibitive tax penalties before capital can be accessed, as discussed in more depth below. In addition, compliance mistakes can cost dearly. Given the headaches that tend to arise for all parties — advisors, trustees, and beneficiaries — it comes as no surprise that a set of ''best practices'' has emerged for FNGTs with only U.S. beneficiaries. Specific FNGT mandates include the approaches of not accumulating income in them, domesticating them, and where possible, avoid creating them in the first place.

While these strategies prove beneficial in many instances and are clearly better than an inefficiently managed FNGT, for a certain subset of U.S. beneficiaries, irrevocably undoing FNGT planning may leave a significant amount of wealth on the table. The decision to domesticate an FNGT is often reached without properly weighing the long-term economic impact. Namely, subjecting a structure to U.S. taxes (by creating it in the United States by domesticating it, or by distributing all of its income to the U.S. beneficiaries annually) may ultimately hamper the beneficiaries' wealth.

When U.S. taxes will be paid for decades on funds without the need for near-term access, careful consideration should be given to an alternative approach before adopting a domestication-centered strategy. In this case, creating an FNGT for a U.S. beneficiary or keeping an FNGT offshore and deliberately accumulating its income — even if all beneficiaries are U.S. taxpayers — may prove advantageous. For some U.S. beneficiaries, keeping funds in an FNGT may result in a substantial enhancement of family wealth, one that makes the inherent complexity and compliance pale in comparison.

In this article, we compare the tax drag on wealth in a U.S. trust and contrast it with the economic benefit from compounded tax savings in an FNGT established for the same U.S. beneficiary. We demonstrate that fear of complexity and its related costs should not drive decision-making, including the location of a trust (either for set up or its ultimate destination). Instead, we propose that timing and access to trust funds represent seminal factors, both at the moment of the trust's creation and even decades later.

U.S. TAXATION OF TRUST BENEFICIARIES — FOREIGN VS. DOMESTIC TRUSTS

The distinction between a U.S. trust and a foreign trust significantly impacts the taxation of its U.S. beneficiaries.

A U.S. non-grantor trust (U.S. Trust) is a U.S. taxpayer subject to U.S. income taxes to the extent it has taxable income. If a U.S. Trust distributes part, or all, of its distributable net income (DNI) to U.S. beneficiaries, the trust receives a distribution deduction and the recipient U.S. beneficiaries are taxed instead. In either case, if income includes realized long-term capital gains or qualified dividends, the trust or the recipient will be taxed at the lower tax rate afforded such income items in the U.S. If the distribution amount exceeds the trust's current income, the excess is treated as a non-taxable distribution of principal in the hands of the recipient U.S. beneficiaries. Thus, all income is subject to U.S. tax in the year in which it is earned, either to the trust or to the U.S. beneficiaries.

Since an FNGT is not a U.S. taxpayer, the U.S. can only ''tax'' its income when a U.S. beneficiary receives a distribution.[2] When such a distribution consists solely of the FNGT's DNI,[3] the U.S. tax treatment of that distribution will match the tax character of that income. As with an income distribution from a U.S. Trust, to the extent that DNI includes realized long-term capital gains or qualified dividends, the distribution will be taxed at the lower tax rate. Similarly, if the FNGT has no accumulated income earned in prior years (UNI),[4] then any distribution that exceeds the FNGT's DNI will be treated as a nontaxable distribution of principal.[5]

However, if the FNGT has UNI, the United States cannot tax that income as long as it remains in the trust. To discourage the accumulation of income in a foreign trust and the resulting deferral of U.S. tax on it, the United States treats a distribution of UNI to a U.S. beneficiary (when a distribution exceeds the FNGT's DNI) as an accumulation distribution[6] and subjects it to both a ''throwback tax'' and an interest charge.[7]

The throwback tax and the interest charge are designed to impose on the U.S. beneficiary roughly the same income taxes that would have been levied had

[2] *See* §652(a), §662(a). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[3] §643(a).

[4] *See* §665(a), §665(b).

[5] *See* §662(a).

[6] *See* §665(b).

[7] *See* §668.

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the beneficiary received the income in the year in which it was earned (treating all UNI as ordinary income which may be taxed at higher rates).[8] Consequently, the longer the accumulation period of the income, the heavier the burden of the throwback tax and the interest charge will be until, at a certain point, the entire distribution of UNI will be consumed by the tax and interest charge levied.

TIMING IS EVERYTHING

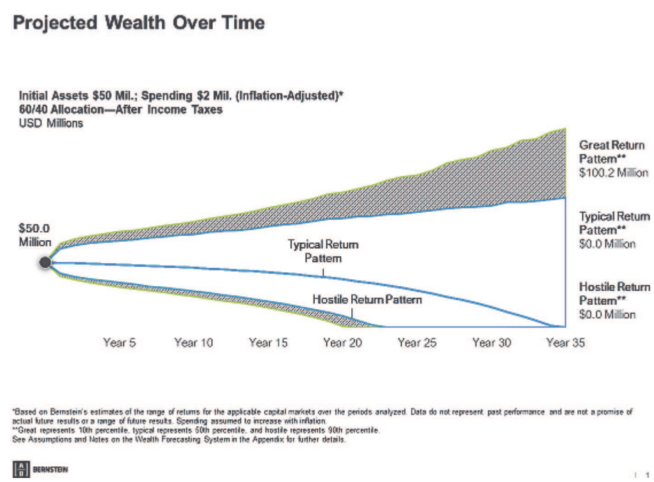
Given these onerous tax consequences, it is easy to see why most U.S. advisors caution against the accumulation of income within FNGTs. However, when U.S. beneficiaries do not need to access the trust's DNI every year, does it make sense to pay U.S. taxes on that income? If the FNGT were left offshore and its trustees were to intentionally accumulate income, would the compounded tax-free growth generate enough family wealth over time to justify the approach? What will access to this wealth look like in the future? Will it suffice for the beneficiaries, or will it forever be ''locked'' in the FNGT? The answers to all of these questions underscore one variable: timing.

Arguably, if beneficiaries do not currently require access to trust funds — and when they do, if their spending needs can be met with DNI alone — there is no reason to domesticate an FNGT and pay U.S. income taxes on the entire trust in the interim. Nevertheless, the prevailing domestication approach remains popular. That likely stems from the tendency of both practitioners and beneficiaries to underestimate the magnitude of the compounded tax savings while erroneously assuming that once accumulated, tax-efficient access to wealth becomes unattainable. In fact, once clients and their advisors appreciate the material impact that U.S. taxes have on family wealth and recognize their ability to access accumulated wealth over time, they are more willing to explore alternatives.

WHEN TIME IS ON YOUR SIDE: AN ILLUSTRATION

The following example illustrates the important role that timing plays in the decision-making process. Consider Astrid, a 40-year-old U.S. citizen who resides in Miami with a liquid net worth of $50 million. As a U.S. citizen, Astrid is subject to both U.S. income taxes and U.S. transfer taxes. Astrid's father, a resident of Switzerland, wishes to give $100 million (the ''Gift'') to his daughter and her descendants, but the creation of a foreign grantor trust is not a viable option due to her father's circumstances. Given that all intended beneficiaries are U.S. citizens, the family's U.S. advisor will likely recommend making the Gift to a U.S. Trust established for the benefit of Astrid and her family. However, this route fails to consider Astrid's existing $50 million net worth as well as the cumulative economic impairment of subjecting the Gift to U.S. income taxes.

What's the alternative? First, examine Astrid's personal circumstances, tax bracket, spending needs, and investment style to quantify how long Astrid can reasonably rely upon her liquid wealth to support her after-tax spending needs. To do so with a high degree of confidence, one should assume poor capital-market returns and higher-than-expected inflation (i.e., a ''hostile return pattern''). While Astrid pegged her annual after-tax spending at $1.5 million, we assumed it stood closer to $2 million (erring on the safe side). Astrid's liquid assets were allocated 40% to bonds and 60% to equities.[9] Using Bernstein's Wealth Forecasting System,[SM] we calculated a 90% chance that Astrid's $50 million would sustain her after-tax spending for 22 years and a 50% chance that it could last as long as 34 years (***Display* 1**).



These projections help pinpoint when Astrid will likely need to tap the trust's funds. By the time she requires initial access, will the FNGT's tax-free growth generate a sufficiently robust DNI stream to sustain Astrid's after-tax spending (adjusted for inflation)? If so, then accumulated UNI could remain in the FNGT, avoiding the dreaded tax consequences that accompany an accumulation distribution. The longer Astrid waits before receiving distributions from the FNGT, the larger the trust will become, generating even more DNI annually. For instance, if As-

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[8] *See* §666, §667.

[9] Stocks are modeled as global equities (70% U.S. equities and 30% developed-international/emerging-market equity). Bonds are modeled as intermediate-term municipals.

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trid waits 22 years before receiving distributions from the FNGT, the trust's DNI will be able to sustain $3.4 million in after-tax annual spending, easily surpassing her needs. And if Astrid waits 12 more years (receiving distributions in year 34), the trust's DNI could sustain $4.7 million of annual after-tax spending while continuing to accumulate any excess DNI that is not distributed tax-free.[10] Notably, these figures only continue to grow with time.

Beyond sustaining Astrid's spending needs, allowing the FNGT to continue growing tax-free for an extended period significantly enhances overall family wealth relative to the amount accumulated in a U.S. Trust that will be weighed down by the annual payment of income tax, by either the U.S. Trust or its U.S. beneficiaries.[11]

Let us assume that Astrid begins receiving trust distributions 20 years after the Gift is made. If her father makes the Gift to a domestic trust (presumably in a state that does not impose income taxes),[12] it will still be subject to federal income taxes the entire time despite the absence of distributions. Alternatively, remitting the Gift to an FNGT avoids U.S. income taxes during the same 20-year waiting period because no distributions are contemplated during that time frame.[13] Foregoing U.S. taxes for 20 years results in $63 million — or over 23% — of additional family wealth. Advisors often underappreciate the magnitude of this compounding effect on the FNGT's value, especially considering that the additional wealth accumulated in the FNGT translates to 23% more annual income[14] versus the domestic trust alternative.

Admittedly, this wealth expansion does not afford the same degree of tax-efficient access to the funds compared to a U.S. trust because a significant amount of UNI will build within the FNGT. Some might even suggest that future enhanced family wealth is of little use to Astrid's descendants since its tax-efficient access will be restricted to DNI while any distributed amounts exceeding DNI will be subject to punitive taxation and interest charges. Had the Gift been made to a domestic trust instead, Astrid's descendants would enjoy unlimited tax-free access to amounts beyond the trust's DNI. In fact, this represents one of the most common objections that U.S. advisors raise when an accumulation strategy is proposed. However, the wealth that accumulates within the FNGT is arguably accessible — just not as immediately as the wealth built-up in the domestic trust.

SLOW AND STEADY WINS THE RACE

Let's revisit our prior example. Suppose that in year 21, Astrid begins receiving annual trust distributions which support $2 million in after-tax, inflation-adjusted spending and that these distributions continue for 20 years until she passes away. If the Gift were made to a U.S. Trust, the value of trust assets on Astrid's death would be $704 million. On the other hand, had the Gift been made to an FNGT, the value of her trust would reach $1.245 billion.[15]

To give Astrid's descendants access to as much wealth as the U.S. Trust holds, the Trustees of the FNGT could begin distributing *all* of the trust's DNI — not just the amount required to fund $2 million of after-tax spending — to a U.S. Trust. Doing so for just 18 years will transfer more wealth onshore while leaving over $1.5 billion in the FNGT, resulting in over 85% more family wealth than if the Gift had been made to the U.S. Trust[16] (***Display 2***).

If Astrid's descendants cannot wait that long, the trustee (and investment advisor) could enhance the beneficiaries' outcomes by employing selective gain harvesting to increase the FNGT's DNI. For example,

[10] Sustainable spending on projected growth of the portfolio prior to spending, assuming 90% confidence levels and 40 years of spending once spending commences (e.g., in 10 years means from year 10 to 50). Assumes 100% global equity allocation in accumulation phase and 60/40 allocation in spending phase. Spending is after-tax and adjusted for inflation. Assumes DNI distributions are made to a U.S. Trust each year where taxes are paid, and after-tax proceeds are available for spending. To the extent there are funds left over after spending each year, funds are assumed to be invested in the U.S. Trust and used for potential spending shortfalls in future years. Amounts depicted do not reflect annual DNI; they reflect sustainable spending that could be sourced from the U.S. Trust that receives annual DNI distributions.

[11] Note that, for the purposes of our illustration, we assumed that both the FNGT and the U.S. Trust assets were allocated entirely to global equities. For such an allocation, most income and capital gains will be taxed at preferential rates. To the extent that trust assets are allocated to investments that are taxed at the higher ordinary rates, the benefits of the FNGT accumulation strategy could be greater than illustrated.

[12] Seven U.S. states currently do not impose an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

[13] To the extent that there are U.S.sourced dividends in FNGT, withholding would apply which would reduce the benefits of the FNGT from what is illustrated.

[14] At year 20, median projected outcome.

[15] Median projected outcomes.

[16] Assumes year 40 wealth of $704 million for U.S. Trust and $1,245 million for FNGT. From year 41-58 returns are modeled as follows: 7% total return including 2% dividends and 5% appreciation with 20% turnover (all long term) for FNGT and U.S. Trust assets. Assumes DNI distributions from the FNGT to U.S. Trust from year 41-58. Assumes no distributions from the U.S. Trust in both scenarios.

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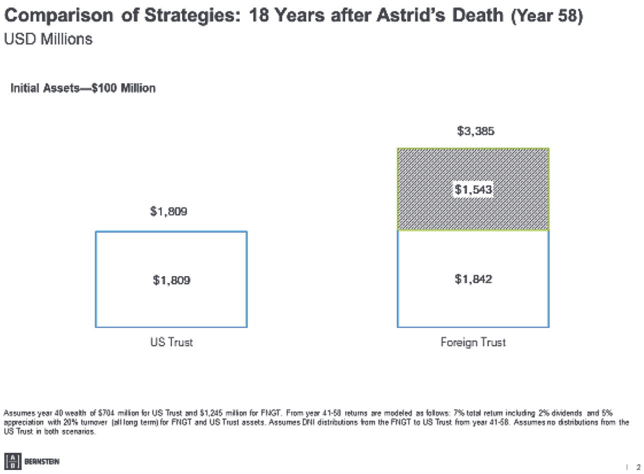
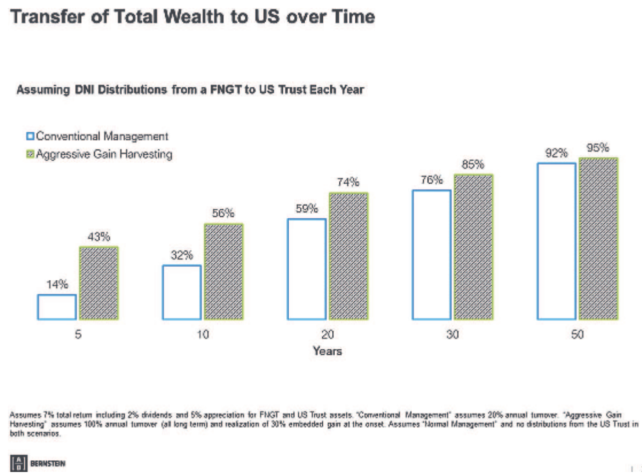


aggressive gain harvesting could shave six years off the period by accelerating the tax-efficient transfer from the FNGT to the U.S. Trust. And, if the trustees realized a 30% built-in gain in an FNGT while pursuing an aggressive gain harvesting strategy going forward, it would take just 12 years to transfer as much wealth to the U.S. Trust. This could be accomplished while still leaving over $870 million in the FNGT, resulting in 69% more family wealth. Surely, for at least some clients, limiting access for a stretch in exchange for gaining nearly 70%-90% more wealth represents a compelling trade-off.

Taking a closer look, we illustrate the transfer of total family wealth over time from an FNGT assuming DNI distributions each year and reinvestment of after-tax proceeds in a U.S. Trust under two different scenarios. This allows us to compare ''conventional management'' and ''aggressive gain harvesting.''[17]

Conventional management assumes an annual turnover of 20% while aggressive gain harvesting assumes the realization of a 30% built-in gain in the first year and the annual realization of all gains thereafter. In both cases, over 90% of the wealth will be transferred over time without access to any UNI. However, with aggressive gain harvesting, the U.S. beneficiaries will benefit from faster, tax-efficient access to more trust funds. For example, aggressive gain harvesting will allow the beneficiaries to tap over 55% of the wealth in 10 years versus just 32% of the wealth with conventional account management (***Display 3***).



LOCATION, LOCATION, LOCATION

For families with funds in both a U.S. Trust and an accumulating FNGT, asset location should be managed holistically, with a focus on holding in the FNGT tax-inefficient investment strategies such as hedge funds, investments in private lending, or any strategy that generates ordinary income and short-term capital gains. Consider a family whose wealth is split evenly between a U.S. Trust and an accumulating FNGT. The clients wish to allocate 75% of their assets to tax-efficient strategies and 25% to tax-inefficient investment strategies. Here, it may be advisable to earmark the entire U.S. Trust for tax-efficient strategies while dividing the FNGT 50% to tax-efficient strategies and 50% to tax-inefficient strategies. This approach reflects the family's desired overall mix, but with increased tax efficiency compared to replicating the 75/25 mix in each structure. For simplicity, let's assume that in the U.S. Trust, a 20% tax rate applies to tax-efficient investments while a 40% tax rate applies to tax-inefficient investments. With the 75/25 allocation, the overall effective tax rate will be 25%. Yet by moving the U.S. Trust allocation entirely to tax-efficient investments — and implementing the 50/50 mix in the FNGT — the effective tax rate of the U.S. Trust can be reduced by five percent.

Notably, an FNGT's allocation should be revisited when contemplating distributions to either U.S. beneficiaries or a U.S. Trust. Before commencing distributions of DNI, the FNGT's asset mix should be shifted back to a tax-sensitive allocation. Thus, while an FNGT can provide additional asset-location benefits to families, it requires careful implementation and monitoring from trustees and investment advisors alike.

CONCLUSION

In most cases, the complexity and associated costs of properly administering an FNGT renders it unat-

[17] All gains are assumed to be long term. Accessing funds sooner through realization of short-term gains is not likely to make financial sense as long as long-term gains continue to be taxed at preferential rates. Assumes seven percent total return including two percent dividends and five percent appreciation for FNGT and U.S. Trust assets. ''Conventional Management'' assumes 20% annual turnover. ''Aggressive Gain Harvesting'' assumes 100% annual turnover (all long term) and realization of 30% embedded gain at the onset. Assumes ''Conventional Management'' and no distributions from the U.S. Trust in both scenarios.

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tractive to U.S. beneficiaries. However, in those instances where a meaningful amount of time will elapse before beneficiaries require access to funds, keeping the trust offshore should be considered — despite the complications. Doing so can result in materially improved economic results for the family without the permanent sacrifice of access that's typically assumed. Often, the costs of complexity and the ongoing monitoring of trust management will seem minor compared to the additional wealth that can be generated. Assembling a knowledgeable team of professionals (including trustees, and tax and investment advisors) who can work collaboratively with the family to support such a strategy will be critical to ensuring its success.

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