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Offshore Trusts and Estate Planning – The Often Overlooked Essentials

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With the dramatically increased globalization of investments, residential property interests, and arrangements to protect assets, the offshore trust has almost become a household word. Although it was true at one time that offshore trusts (that is, trusts settled in a jurisdiction other than that of the settlor¹) were employed primarily by the wealthy and the stealthy, nowadays, it is not at all unusual to find such trusts established by professionals, business persons, retirees, and even “average” families with moderate wealth. The problem is that in most cases these trusts are regarded and often drafted as separate from the rest of the settlor’s estate documents, and thus are not coordinated with the settlor’s estate plan. This can lead to tax problems, direct conflicts with the settlor’s dispositive plan, and even lawsuits. This discussion highlights the more important items to consider when designing and implementing an offshore trust, primarily from the standpoint of a U.S. settlor, although some similar observations would generally be appropriate for a UK settlor, since both are common law jurisdictions that impose a death tax.²

¹ For a U.S. settlor this means outside the U.S.

² The UK Finance Act 2006 imposes a tax on certain lifetime transfers to trusts that could be regarded as a gift tax, though it is referred to as an inheritance (death) tax.

As noted, the usual focus of the offshore trust is to deal with the offshore assets, most often having the settlor as the primary beneficiary of the trust. This is not at all to say that the trust would not provide for other discretionary beneficiaries during the settlor's lifetime or for remainder beneficiaries at the settlor's death, but rather that frequently the provisions of the offshore trust are not coordinated with the provisions of the settlor's other documents, and thus with her overall plan. In some instances, this lack of coordination can produce seriously adverse tax results. For instance, say that the terms of the offshore trust provide that on the U.S. settlor's death the trust assets will be held in trust with discretionary distributions to her spouse. At the same time, the settlor has had the typical estate documents prepared at home, and these documents have already provided the "optimum" share for her spouse to result in the least estate tax. Depending on the size of the settlor's estate and the terms of the offshore trust, the additional bequest to the spouse from the offshore trust could result in thousands of dollars in extra in taxes on the settlor's death. Similarly, if the offshore trust provided for the remainder to pass to the children instead of the settlor's spouse, the extra amounts from the offshore trust could upset the usual formula for maximizing but not exceeding the U.S. exclusion amount (or the UK's nil rate band), again resulting in payment of thousands in extra estate taxes on the settlor's death.

Taxes may not be the only potential source of problems. Frequently the offshore trust is designed to be administered during a specified period but not longer than the settlor's lifetime. In such a case, if the trust does not provide for termination or at least distribution of the assets to the settlor's domestic trust at the settlor's death, the trust may be required to continue in the foreign jurisdiction at added expense, possible tax complications, and inconvenience to the beneficiaries.

The fact of the matter is that the offshore trust should be viewed and drafted as an integral part of the settlor's estate plan. If the offshore trust is to be funded with a substantial part of the settlor's estate, many U.S. and UK firms will draft that trust as the central trust in the settlor's estate plan. In such cases, the offshore trust will contain not only the obvious provisions for the settlor during her lifetime, but also the necessary tax clauses, formulas, and allowance for tax elections so necessary to producing the least amount of estate tax and avoiding unnecessary income tax or

possible penalties. At the same time, the trust will provide for an optional change of situs at the settlor's death, so that, if the protector or the beneficiaries decide, and if the trust assets are not jeopardized by so doing, the trust can easily be moved to the U.S. (or UK) or to any other jurisdiction that is in the best interests of the trust and the beneficiaries.

If the offshore trust does not hold the substantial portion of the settlor's assets, it could be drafted in a simpler fashion, with the provision that on the settlor's death the offshore trust would "pour over" its assets to the settlor's central (domestic) estate planning trust, to be administered according to that trust. NOTE, however, that this arrangement may subject the offshore trust assets to the settlor's creditors on the settlor's death.

The "protector" mentioned in the foregoing paragraph can prove to be an important party to any trust, but particularly an offshore trust. Briefly, a protector is a person (or entity) who has powers over the trust but who is not a trustee. The protector's powers can be narrow or limited (such as the power to veto distributions, or the power to remove and replace trustees, or the power to relocate the trust and change its governing law, or the power to approve trust investments), or they can be very broad (such as the power to amend the trust or to add or delete beneficiaries). The extent of the protector's powers in any given situation is a matter for the settlor and her advisor, but as a general rule, the greater the protector's powers, the greater the flexibility to deal with unforeseen issues or with problems resulting from a failure to have integrated the trust with the settlor's estate plan. At the same time, however, the greater the protector's powers the greater the need for careful drafting and coordination with the settlor's overall estate plan. And in my opinion, the settlor should not be the protector nor should any beneficiary of the trust. Furthermore, for offshore trusts where asset protection is a function, the protector should not be a person or entity subject to the jurisdiction of the courts of the settlor's domicile.

Although I noted that it is often desirable for the protector to have broad powers, in the interests of maintaining consistency in the settlor's estate plan, the drafter should consider providing that any changes by the protector to the trust's dispositive or tax scheme will require the consent of the settlor. This requirement of consent will not expose the trust assets to the settlor's creditors

nor have any other adverse impact, but it will ensure that the settlor's dispositive scheme is not inadvertently changed. If a protector is to be included in the offshore trust, and I strongly recommend that it is, adequate provisions should be included for the office. For instance, provisions for removal of the protector and appointment of successors, for resignation, for compensation, etc.³

In many cases, however, while it appears that a trust protector would be useful at some point, the trust may not need a protector at the outset. After all, appointment of a protector carries with it the attendant though usually nominal fees for the periodic monitoring of the trust and the trustee, and for carrying out the exercise of powers, where there are some to be carried out. To simplify matters and avoid the involvement of a protector if none is needed at a given time, I recommend drafting the trust to provide for a "springing" protector. That is, although the trust would make reference to and anticipate the appointment of a protector, no protector would be appointed at the inception of the trust. Nevertheless, the trust would provide that at any time the trustee or a third party or parties would have the power to activate the position and appoint the party originally selected by the settlor as protector (or a successor, as applicable). The appointment could be permanent or for a specified period of time, or even for a specified purpose. Of course, the trust would contain all the other provisions appropriate to the office, but until the protector springs into being to perform its function, such as to settle a dispute, amend the trust, change the situs, etc., the trust would operate without one.

As for tax consequences to the settlor, most offshore trusts that are properly coordinated with the settlor's overall estate plan are U.S. tax neutral for income and estate tax purposes, although there could be some situations where tax planning is involved. Briefly, for U.S. planning purposes these include pre-immigration planning for non-U.S. persons who will become U.S. persons in the future, or planning by U.S. persons to establish foreign non-grantor trusts after their death. In the case of pre-immigration planning, a non-U.S. person can establish an offshore trust at least five years before immigrating to the U.S., and that trust may provide significant U.S. income tax benefits to the settlor after her move to the U.S.

³ For a more thorough discussion of trust protectors, see: Alexander A. Bove, Jr., "The Trust Protector: Friend or Fiduciary?", Chapter 6, *Asset Protection Strategies Vol. II* (Alexander A. Bove, Jr., ed., American Bar Association 2005).

In the case of the U.S. person, she could establish an offshore trust in a tax-free jurisdiction, directing the trust to accumulate tax deferred income for a number of years after her death, allowing the trust to grow at a much faster rate than it would in a jurisdiction (such as the U.S.) that taxes income and capital gains on an annual basis. After a pre-determined number of years of accumulating income, the trust could allow distribution of up to all of its current income to its U.S. beneficiaries (e.g., the settlor's children, grandchildren, etc.). Although such distributions would be subject to regular income taxes, the huge accumulation of untaxed income (which itself would generate substantial current earnings), if never distributed, would never be taxed.

To illustrate the advantage of this arrangement, say that Charles, a U.S. person, funds an offshore trust with \$2 million on his death. The trust is required to accumulate all of its earnings for 20 years. At six percent after expenses, the \$2 million would grow to \$6.4 million in that time. Assuming the same six percent net return continued, the trust could distribute up to its annual earnings of over \$380,000 per year to its beneficiaries subject only to current income taxes. The growth of \$4.4 million on the original \$2 million, if undistributed, will not be taxed, and in a number of offshore jurisdictions, there is no limit on the duration of the trust

In sum, while offshore trusts have a number of specific attractions, it is critical that they should not be viewed as stand-alone documents independent of the settlor's overall plan. And although they can certainly offer benefits that may not be available in the settlor's domicile, at the same time they must be drafted in a way that carefully coordinates those benefits with the settlor's overall plan, both during the settlor's lifetime and at the settlor's death.

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