Asset Management for Offshore Trusts with U.S. Beneficiaries

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Offshore trusts with U.S. beneficiaries have unfortunately become synonymous with dubious tax schemes. Wrongly so, since there are many legitimate reasons for a U.S. person to establish a trust in an offshore jurisdiction, such as for asset protection or to benefit non-U.S. family members. Similarly, many U.S. persons, particularly first- and second-generation Americans, derive benefits from trusts established by their parents or other family members who are not U.S. persons. U.S. dual citizens residing abroad also benefit from non-U.S. trusts or establish trusts offshore because they live abroad, but face the same U.S. tax issues as if they were living in the U.S. Finally, there are many U.S. trusts that invest offshore for diversification.

For U.S. connected trusts, finding the proper offshore trust providers is challenging due to the demands from a U.S. tax perspective and as a result of the offshore trust market. The offshore trust market differs from the onshore market in many ways including the fragmentation of services and the historical role of the trustee. Whilst onshore, trust companies often are related to asset managers and have an understanding of U.S. tax issues driven by a fiduciary duty and business competency; in the offshore environment many trust companies offer only basic trust services. Fragmentation results in the need for many actors to be involved in the proper administration of offshore trusts with U.S. connections.

Coordination is key

Given the number of parties potentially involved in such a structure, it is apparent that coordination among the different entities is key. Regular interaction and alignment between the stakeholders is crucial to efficiently understand the objectives of the structure, to improve the after-tax and cost performance of the underlying assets, ensure proper tax filings and make the operational processes between the players work optimally. This implies that some parties will perform tasks beyond their normal duties. The role of the asset manager illustrates the importance of coordination with the trustee and an understanding of U.S. taxes.

The central role of the asset manager, as fiduciary, is to achieve the best possible net after-tax return for the client taking into account the investment strategy, risk tolerance and long-term objectives of the structure as determined by the trustee or the investment committee of the trust. The trustee must be involved in setting this policy. Timing of income recognition is a particularly relevant issue in the context of the U.S. tax implications of benefiting from a non-U.S. trust.

To achieve the goal of solid after-tax performance, the asset manager must perform his core activities in conjunction with all other parties. Thus, when seeking an offshore asset manager, a trustee or investment committee should evaluate the asset manager's knowledge and understanding of U.S. tax law, including differences between grantor and non-grantor trust investing, the taxation of accumulation distributions, the anti-deferral regimes (i.e. passive foreign investment companies), withholding taxes and tax treaties, qualified dividends and the

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taxation of certain structured products. The difference in taxation of these products can substantially impact the returns realized by the trust or the U.S. beneficiary.

Partnerships with experts

An asset manager cannot operate alone and the custodian bank for the assets serves as a valuable partner in delivering U.S. tax reporting to the client. Trustees should look for custodians who are committed to servicing U.S. taxable accounts including the ability to provide IRS 1099 reporting, which includes currency-adjusted cost-basis reporting for non-U.S. securities. Furthermore, a strong partnership with an accountant and/or tax lawyer is important to develop policies of the trust and maintain compliance.

Many offshore banks hesitate to communicate with U.S.-based counterparties. Often, the asset manager is the only party interacting between the offshore parties and the onshore partners. More active trustees may involve themselves with tax matters, but generally in the context of an offshore trust the asset manager takes the role of ensuring that information in the tax statement is reflected correctly.

Even seemingly simple issues, such as a request to generate liquidity, entail important U.S. tax implications: Which asset should be sold, what is the portfolio impact from a performance, tax and cost perspective? Issues involving tax credits, particularly in the context of non-grantor trusts investing into the U.S., also drive the investment approach.

The issues above highlight concerns that involve not only the asset manager, but also the trustee, the accountant, the custodian bank and the lawyer. The old adage "the devil is in the detail" is particularly relevant for service providers working with U.S.-connected offshore trusts. With a view to this complexity and associated risks, it is necessary to work with partners who have made the U.S. market a core competency of their business.

Trustees should look to investment advisers registered with the U.S. Securities and Exchange Commission (SEC) to help mitigate these risks. SEC registration offers protection for U.S. beneficiaries and reduces risks for offshore trustees with respect to their fiduciary liabilities and when communicating with the U.S.-based beneficiaries about the investments.

Seeking out providers with specialized knowledge

U.S.-connected trust structures are an important market segment, and whilst many offshore providers are shying away from serving these structures as a result of the tainted view and complexities of these structures, the result is a segmentation of providers. U.S. persons settling or benefiting from offshore trusts should seek out providers with the specialized knowledge to guide them through the complexities of U.S. tax and regulatory oversight to achieve optimal, cost-effective and compliant trust solutions.

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