

C M S K Y E

CM Notes

OFFSHORE TAX PLANNING FOR US PERSONS WHAT IS POSSIBLE AND WHAT IS NOT

1. General Overview

- 1.1 US persons for tax purposes include all US citizens, wherever they are resident in the world, all persons holding 'Green cards', wherever they may be in the world, and all persons resident in the USA by virtue of staying in excess of the defined period each year.
- 1.2 A US person, no matter where he is resident, is taxed on a world wide basis; on his world wide income; world wide capital gains; worldwide assets; worldwide gifts and estates.
- 1.3 The only mitigating features for a non-resident US person are the tax free earned income allowance of \$75,000 per annum, and any Double Tax Treaties that may exist between the USA and his country of actual residence.

2. Immigration (If this section is not relevant, please go straight to section 3).

- 2.1 An immigrant is in exactly the same position as a US citizen.
- 2.2 If, therefore, a person proposes to immigrate into the USA, by whatever mechanism, he will become a US person for tax purposes. In addition to the normal regime of Federal, State and local taxation, he has some other special obligations. Any trust established by him in favour of anyone, anywhere, within the five years previous to arrival in the USA will have to be declared to the IRS.
- 2.3 Tax planning prior to arrival, with a view to sheltering assets from US taxation is difficult, and complex. The assets can, of course, always be gifted away in their entirety, but that precludes any possibility of later recovery. Apart from that, the available options are very limited, and are described in this paper.
- 2.4 However, unlike the US citizen, the resident alien can always leave. Once he has left, US tax liability will fall away. It is, however, more difficult for a Green Card holder to escape than an alien on a simple business visa. US citizens who renounce their citizenship to escape US tax will find that they may not escape after all, since if that is the primary reason for the renunciation, it may not be accepted by the IRS. Even for the departing alien, however there are traps. The act of ceasing to be a US person may trigger off capital gains tax on Foreign Grantor Trusts established during the alien's residence in the USA.

This is a severe drawback in the use of foreign Asset Protection Trusts for a resident alien, and Asset Protection planning requires a different technique.

- 2.5 The possibility of the eventual escape of an alien, however, gives opportunities for long term tax planning, especially where deferral is the objective of the program. The US citizen faces more severe difficulties.

3. 'Offshore' Tax Planning?

- 3.1 Over the years, US tax law has become tighter and tighter. Today, there is nothing to be gained, from a pure tax viewpoint, by a US person in using an offshore jurisdiction, as such, for the avoidance or deferral of taxes. Any tax program that works is effective both onshore and offshore. There is no difference. There is nothing that can be done offshore that cannot equally be done onshore. That said, there are some considerable disadvantages of going outside the USA (e.g. extra reporting requirements), which are matched by some considerable advantages of going outside the USA (e.g. Asset Protection planning; better investment opportunities). There are also advantages in contractual structures with offshore entities in the context of long term deferral.

4. Using an offshore company?

- 4.1 The use of a simple offshore company, as such, achieves no tax benefit whatever, but can make matters considerably worse.
- 4.2 Since 1997, the definitions of what, for US tax purposes, is a company, a partnership or a trust have been determined by reference to the *Check-the-Box Regulations*. In this, the first question is whether the entity is included in the so-called 'per-se' list of entities. If it is, then its classification is clear, and carved in stone. If it is not on the list (and virtually no offshore entities are), then the question is whether the entity is for the purpose of conserving and preserving assets. If it is, and if it has no commercial objectives that imply commercial risk, then it is a trust for tax purposes, no matter what its legal form may be. Thus, there are many offshore holding companies which are, for tax purposes, trusts, and ought to be reported as such.
- 4.3 If it does have commerciality, then if all its members have unlimited liability, the entity is a default partnership, and if this is not the case, it is a default corporation. However, in both cases, there is provision for the entity to elect to be treated otherwise. Thus a commercial LLC will be a default corporation, but can elect to be treated as a partnership.
- 4.4 If the entity is defined as a partnership, then it is wholly transparent for tax purposes. Every taxable event is projected directly and immediately into the tax liabilities of the partners. This may, however, be a positive advantage, if there is a need for a US person to hold assets through an overseas corporation, as we shall see.
- 4.5 LLCs were originally intended to be default partnerships. Under the 1997 *Check-the-Box Regulations*, they will normally be default corporations, but this is not a difficulty since it is possible to elect for the LLC to be treated as a partnership nonetheless.

5. A default corporation is bad news

- 5.1 If the entity is characterised as a Corporation, then there are numerous provisions that catch it. Any overseas corporation in which 50% or more of the capital is owned by 5 or fewer US persons, is a Controlled Foreign Corporation. This relates not only to voting control but ownership by value. Income derived from non-trading activities is 'Sub Part F Income'. There are also other traps in the Internal Revenue Code. For a CFC, there are enhanced reporting requirements, the effect of which is that all taxable Sub Part F income and Capital gains are taxed to the US owners. In addition to these requirements, there is a distinct penalty provision in relation to Capital Gains Tax.
- 5.2 There are other ways of getting caught too. It could be a Foreign Personal Holding Company or even a Passive Foreign Investment Company.
- 5.3 Quite apart from the enhanced reporting requirements implicit in a Controlled Foreign Corporation (CFC), there is a distinct penalty provision in relation to Capital Gains Tax.
- 5.4 For a CFC, on the death of the US shareholder, certain punitive rules apply in relation to basis step-up. (s.1246(e) and 1291(e)). (For the layman, *basis* is the base value of the asset for Capital Gains Tax purposes. *Step-up* is the increase of the basis which occurs when the asset is sold or transferred to another party, and which triggers off the Capital Gains Tax liability (or "causes the liability to be *recognised*".) On the death of a US person, his estate is subject to Estate Tax, and Capital Gains Tax is forgiven, thereby providing a tax free *basis step-up*. In respect of holdings in a CFC, there is no such forgiveness, and this could easily result in the tax payable being greater than the value of the assets.
- 5.5 Bearer Shares are very bad news too. Whoever in reality controls or enjoys the benefit from such shares is the shareholder. The existence of a bearer Share could also be a constructive trust and reportable as such. See 6.8 below.

6. A default Trust can be bad news

- 6.1 In the US tax system, a Trust is a taxable entity. It is unfortunate that the word 'trust' was used, since the tax definition is very different from the legal definition of a trust - it would have been better if the tax definition had been termed a 'fiduciary vehicle'. So the term 'trust' in the Internal Revenue Code includes every form of structure which has no commercial objectives, and which is in being for the purpose of the preservation and conservation of property. That includes Foundations, and sometimes even holding companies.
- 6.2 For tax purposes, somebody always 'owns' a trust. The 'owner' is the person capable of benefiting. Thus, the suggestion that a Purpose Trust escapes US tax because there is no beneficiary is preposterous. The IRS simply looks at the facts. Who, in fact, is benefiting? It might be the trustee himself!
- 6.3 For Tax purposes, Trusts are either *Grantor* or *Non-Grantor* Trusts. A *Grantor Trust* is a Trust where the *Grantor* (who is the person from whom the trust assets originated), or his close relatives, is capable of benefiting. In the case of a *Grantor Trust*, all tax events are attributed to the *Grantor*.

- 6.4 Thus an offshore trust with a US Grantor achieves absolutely nothing for tax purposes, except considerably increased reporting requirements. If tax mitigation is not the objective, then an offshore trust can be significant for Asset Protection, however.
- 6.5 A trust established by a Non-Resident alien grantor with US beneficiaries having fixed interests, unless it is a revocable trust, is classed as a Non-Grantor Trust. All taxable events are projected immediately onto the beneficiaries, whether they receive any benefits or not. The Trustee must appoint an agent in the USA to supply information to the IRS on demand, and the IRS is notified.
- 6.6 If the US beneficiaries do not have fixed interests, but have only discretionary interests, then they are not taxed until they receive an actual distribution. Such distribution is deemed to have been made from the earliest income accumulation of the Trustee, and a hefty interest charge is applied from such date to the actual date of the distribution.
- 6.7 If the Non-Resident alien subsequently becomes resident in the USA, he too must declare the existence of any trust established outside the USA within five years prior to his arrival, irrespective of who the beneficiaries are.
- 6.8 Bearer Shares issued by overseas corporations, and held by an overseas attorney to the order of a US person are Trusts, and must be reported as such. Even simple holding companies can be classified as trusts. Foundations and 'Hybrid' companies may be Non-Grantor trusts if any US person has any element of ownership or enjoyment of the assets.
- 6.9 Using a 'dummy' grantor is very dangerous. A 'dummy' is just that, - a dummy. The tax law looks straight through this pretence at the reality. A person who allows himself to be used as a 'dummy' grantor where the intention is to hide the reality and perpetrate a deliberate deception, is a party to criminal fraud, and likely to be treated accordingly, if found out.

7. Is there no way around this?

- 7.1 In a word, NO. If any US person has any element of ownership or control over an overseas corporate entity it will be classified as a CFC. The de facto ability to appoint Directors is enough. The mere fact that somebody overseas will always do the bidding of the US person is enough. If there is any fiduciary relationship between an overseas entity and a US person, then there will be a trust, which must be reported.

8. What then is available to a US person?

- 8.1 The only possible mechanisms for tax planning are through either Contractual Forms, or through Charities.
- 8.2 There is one exception to this. Incompletely constituted trusts can be used for deferral of income. So-called *Rabbi Trusts* are used whereby a corporation can pay in the remuneration of an employee, and obtain a deduction as such, but because the remuneration does not actually reach the employee, and because the assets in the trust are still available to the creditors of the company should it fail, the employee is taxed only

when he actually does get the assets, which may be many years later. In the meantime, he gets the benefit of growth from the larger sum.

- 8.3 In addition, where a trust is established by a non-resident alien, and the trust is REVOCABLE, it will be treated as a Grantor Trust, and distributions to beneficiaries resident in the USA will be tax free. However, this has usefulness only in short term situations, where, for example, a non-resident alien father wishes to provide for a son studying in the USA.
- 8.4 Contractual forms include Life Assurance Policies, which give great benefits. During the lifetime of the policy, the assets belong to the Life Assurance company, and so are not taxable to the policy holder. If the Life Assurance Company is overseas, US tax will not apply at all. If the life assured lives more than three years after the policy begins, the death benefit is tax free when he eventually dies. They are, however, expensive, and inflexible. The Internal Revenue Code lays down strict rules both as to the amount of death benefit that there must be, and also the manner in which the assets are invested and managed.
- 8.5 Other contractual forms include Private annuities, which defer tax in much the same way as a *Rabbi Trust*.
- 8.6 Finally, there is a class of contractual forms using Derivative Contracts for Differences. These are highly complex, and difficult to get right, but also very effective as deferral vehicles. They convert income into capital gains, and then defer it indefinitely. They collapse the value of assets for Estate and gift tax purposes too. They are very expensive to run. They are only for the very wealthy! If they are not absolutely right, they are highly dangerous. I have seen attempts at such programs set up in Caribbean jurisdictions, which have been and are time bombs. They should never be used without a legal opinion from an attorney whose opinion carries weight.
- 8.7 Finally, we come to charities. Onshore charities are highly effective mechanisms for tax reductions, and, in conjunction with Life Assurance policies, they can be magic! Donations to US charities registered under section 501(c)(3) of the Internal Revenue Code qualify for a tax deduction. An overseas charity does not so qualify, unless it is also registered in the US, or is itself a tax transparent vehicle (e.g. an LLC which has elected to be treated as a partnership) wholly owned by a US charity. Once the donation has been made and deduction obtained, the US charity can gift the overseas charity as part of its charitable program.
- 8.8 The world of charitable Foundations is a whole world into itself. Essentially, it has to be recognised that, for the very wealthy, the power of control and patronage is more valuable than actual ownership. Thus, by giving the assets away into a private charitable Foundation, control can be retained, even though the assets are gone. This is not a real handicap, since the assets can be replaced eventually by a properly organised Life Assurance policy or policies.
- 8.9 In the USA, itself, Charitable Remainder Trusts provide a means not only of maintaining control, but also of receiving (taxable) income from a capital fund which is not liable to Capital Gains Tax, and thus the income flow is enhanced.

- 8.10 In addition, these structures can be combined with Derivative Contract structures, so that, when the client eventually dies, the heirs receive a sufficient inheritance tax free, while a charitable foundation controls the family wealth with all its power to bestow patronage and invest into joint ventures with the next generation of the family.
- 8.11 It may be taken for granted, therefore, that apart from simple Rabbi Trusts, anything is going to be complex and expensive. Before contemplating anything else, consideration should be given to a Life Insurance Policy with a Life Insurance company whose product can be supported with a US legal opinion.

9. Citizenship

- 9.1 Since US citizenship automatically implies US taxation, it is not unusual for US citizens residing overseas to acquire another citizenship, and thence renounce US citizenship.
- 9.2 The first issue is which citizenship to acquire? It is highly desirable to acquire a citizenship which commands wide visa-free travel (including to the USA). European Union citizenships are popular, but difficult. Ireland provides an automatic citizenship for anyone with an Irish born parent or grandparent. Israeli citizenship is open to those with Jewish forebears. Apart from that, some Caribbean nations have citizenship programmes. Sometimes a new nationality can be acquired by marriage.
- 9.3 Renouncing US citizenship can be complicated. If the IRS believe that the motive is tax avoidance, they can refuse to recognise the renunciation. In addition the act of renunciation can trigger off capital gains tax liability on unrealised capital gains. Care is needed. Take proper legal advice from somebody qualified to give such advice

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