NEW TRUSTS

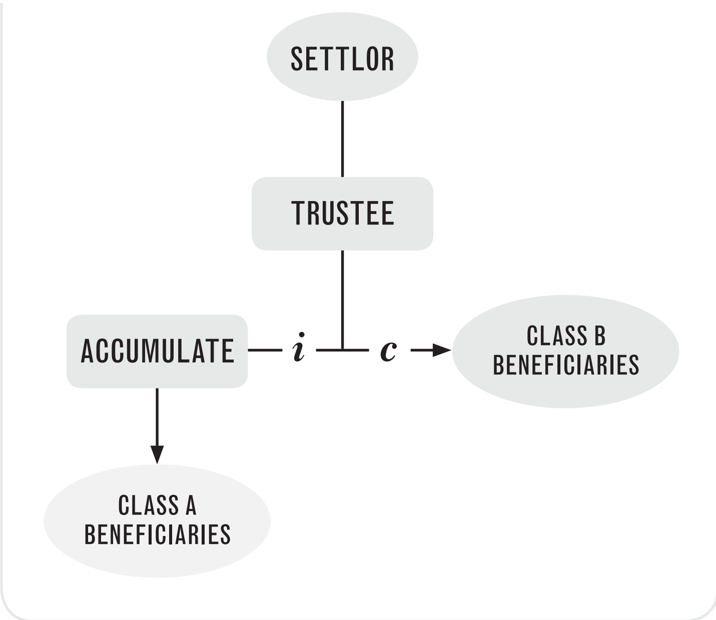
By Milton Grundy

The trusts I am going to discuss are “New” in the sense that they are trusts which I have devised fairly recently. They were designed to solve specific client problems. These have been mainly UK tax problems, but those of my readers who do not concern themselves with UK tax problems do not have to stop reading here: I am not going to dig into the nooks and crannies of the UK tax system; I shall stay with general concepts – assets and values, income and capital, commercial and non-commercial, and I hope that at any rate some of what I have to say will be relevant to each of you, whichever side of the Cliffs of Dover you come from.

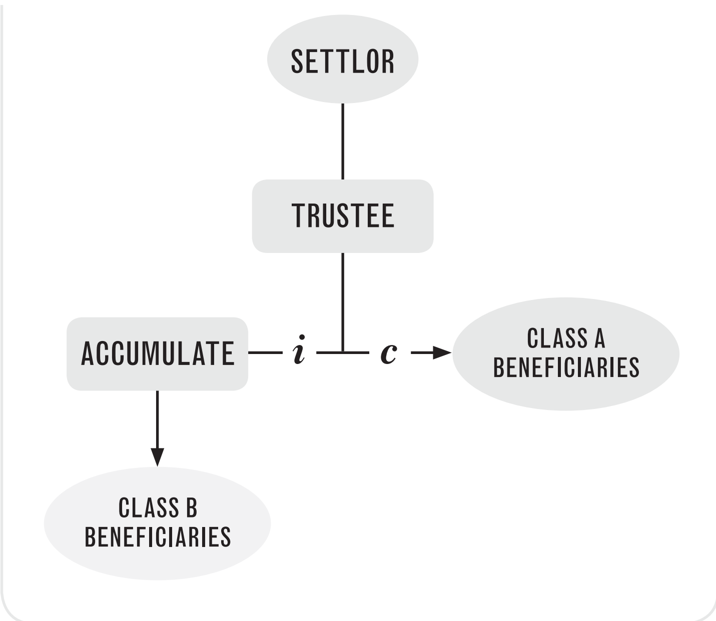
My first New Trust I call the Twin Trust. It is the least new of the four. The Twin Trust is a structure which is useful where the beneficiaries reside in countries which distinguish between income distributions to beneficiaries and capital distributions to beneficiaries. The United Kingdom is one such country, and our courts have spent many years explaining the difference – not altogether satisfactorily, but I think it is plain that a payment made to a beneficiary out of the income of the trust fund is going to be treated as income in the hands of the beneficiary and taxable as such, while a payment to a beneficiary made out of the capital of the trust fund will be treated as capital – at any rate so long as it is not part of a series of regular amounts and not expressly made for meeting living expenses. The Twin Trust is a mechanism for ensuring that payments to beneficiaries have a capital source. And the mechanism is just as effective for offshore trusts as it is for domestic trusts, and I should mention here too that UK beneficiaries have a defence against the tax imposed by those provisions we commonly call “section 720” – and, I guess, the corresponding provisions in Ireland – on the basis that, during the currency of the trust, the accumulated income cannot be “used directly or indirectly for providing a benefit” to an individual.

The diagram (opposite) shows two offshore trusts, each in the same form and with the same settlor. I have divided the beneficiaries into two more or less equal groups, which I show as *Class A* and *Class B*. In the Left Trust, the income is accumulated for the benefit of the Class A beneficiaries. The benefits the Class B beneficiaries get come out of capital which is untainted by any income. The same is true of the Right Trust, but the other way round. There the income is accumulated for the benefit of the Class B beneficiaries, and the benefits to the Class A beneficiaries come out of untainted capital. Of course, this cannot go on for ever. But it can go on for quite a long time. If – to take “toy” figures – the trust investments yield 4% a year, made up of 3% income (after withholding tax) and 1% capital gain, and the trustees in each case make distributions each year to beneficiaries, amounting altogether to 4% of the original capital, then at the end of 33 years the trust fund will in each case still have the same value, but the investments will all be in the accumulation fund. What to do then, I am happy to leave to my successor. The beneficiaries can hardly complain if I have given them a 33 year tax holiday. Who could ask for more? But if I may give my successor a tip, he – or she – might look at the possibility that the trust come onshore, so that each class of beneficiaries together can sell their interests to an offshore purchaser for a capital sum.

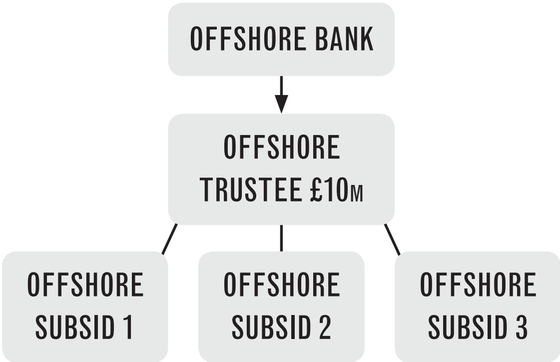
LEFT TRUST



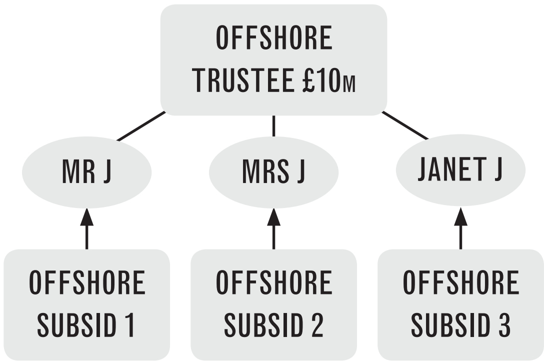
RIGHT TRUST



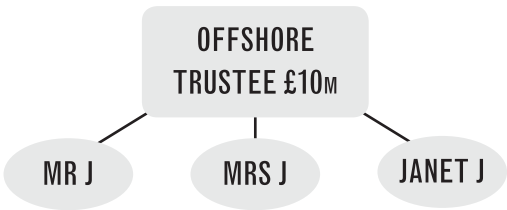
So to the next New Trust, which I have called the "Fortress Trust". The Fortress Trust is like a play in three acts. Act One takes place wholly offshore. There are many variants, but typically what happens is this.



An offshore bank settles – say - £10m on trust for its three offshore subsidiaries. The trustee is also offshore. It is to hold the trust fund on trust to accumulate the income throughout the accumulation period, and subject thereto for the three subsidiaries in such proportions as they may unanimously decide, with discretion in default. It is a feature of this trust that the interest of each one of the subsidiaries is freely assignable. By itself, a beneficiary's interest is not worth very much. An assignee, like the original beneficiary, is not entitled to anything until the end of the accumulation period – which can be 125 years nowadays, under English law. And what he gets then depends on what he can agree with his fellow-beneficiaries, and, if there is no agreement, it will depend on how the trustee will exercise his discretion. On the other hand, the value of the three interests, taken together, will always be the same as the value of the trust fund, and if the beneficiaries, acting together, decide they do not want to wait 125 years, but want the trust fund distributed to them immediately, the well-known rule in *Saunders v Vautier* tells us that they can require the trustee to distribute the trust fund to them immediately. It is also a feature of this trust that it confers extensive powers on the beneficiaries – powers to change the trustee, power to amend the trust deed and so on, but these can also be exercised only by unanimous decision of the beneficiaries. The bank now looks for customers – people who would like to buy these trust interests. You may be wondering why anyone should want to buy them, but that is something I shall come to in a moment.

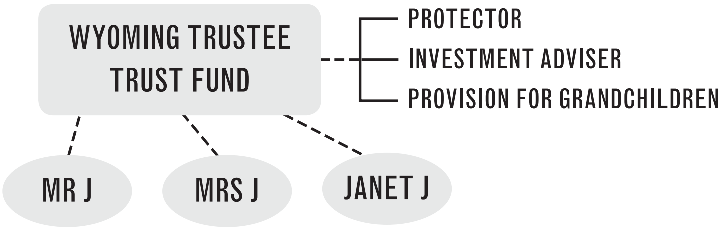


Customers have now been found, and the curtain rises on Act Two. Enter three onshore investors – Mr Jones, Mrs Jones and their adult daughter Janet. Each of them buys an interest in the trust from one of the subsidiaries and takes an assignment of that interest. The price may not be the same in each case, but the total is going to be £10m plus a premium – the premium being effectively the bank's profit. The bank and its subsidiaries retire from the scene, and what we are left with is this.



Before we look at the possible tax advantages of this investment, it is worth spending a moment on its asset protection consequence for the investors. Suppose Mr Jones becomes bankrupt, and his trustee in bankruptcy takes possession of Mr Jones's interest in the trust. It is not an asset of significant value: it is no more than the right to sit out the remainder of the 125 years and hope the Trustee exercises its discretion in his favour. I cannot see that the trustee has any cause of action against Subsidiary One, which sold Mr Jones what he wanted as a commercial bargain. And the trustee in bankruptcy has no shadow of a claim against the £10m, other than the hope of a distribution after 125 years – which means, in practice, that he will do a deal with Mrs Jones and Janet on more or less any terms they offer. The asset protection aspect of the Fortress Trust is to my mind a signal advantage of this structure – an advantage which, as we shall see, it can confer on an insurance policy. It serves to remind us too, when we are thinking of its tax consequences, that it is a commercial transaction and not (at any rate for UK tax) a "settlement".

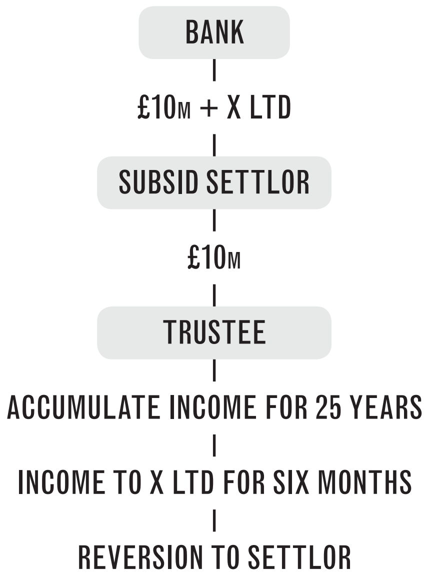
Which brings me to Act III of this drama. Looking at the transaction from the point of view of the Joneses, they have bought interests in a trust not made for them but made for sale. It is rather like buying an off-the-peg suit: it is basically what you want, but still needs some adjustments here and there. The Joneses may want to have their own investment advisers. They may want to make provision for children and grandchildren, or appoint a protector, or have provisions permitting donations to charities or disenfranchising divorced spouses or creditors, or – in today's atmosphere – cleanse the structure from everything offshore by replacing the trustee chosen by the bank with a trustee established in New Zealand or Wyoming, thus.



What the Joneses have essentially bought is freedom from creditors and a machine for holding all those things wealthy people want to control – a significant interest in a public company, yachts, art, Caribbean Islands and so on, with no significant exposure to creditors or – which is an important feature – to tax on gifts, emigration or death, and the ability to accumulate income and capital gains without any exposure to tax, other than withholding tax. If the clients are resident for tax purposes in the United Kingdom, then once more, the spectre of s.720 comes to haunt the UK practitioner. The reason why I do not regard s.720 as a problem is summarised in the Appendix below. The UK system also has the feature – and I think it is shared by the tax systems of many other countries – that benefits to beneficiaries not in the form of money, or of something that can be turned into money, are not taxable. I am thinking here of beneficiaries for example sailing in a boat owned by the trust; that is, in effect, a way of meeting the expenses of running a boat out of untaxed income. Whether or not purchasers of interests in Fortress Trusts are liable to tax by reference to income or gains of the Trust or by reference to any benefits they receive is primarily of questions of law – the law of the tax regime to which they are subject. But the exposure of each of them to capital taxes – on death, gifts, emigration – is going to turn primarily on the question of the value of the interest in the trust – which, as I have indicated, has at most a nuisance value, and if that is right, it is right as a fact, and it is as so whether we are talking about UK inheritance tax or US or Canadian exit tax or any form of tax on death. There is a feature about the acquisition of an interest in a Fortress Trust which troubles some people, and that is that it effects an immediate diminution in the value of the purchaser's estate: yesterday he has X million pounds; now he has an asset of only nuisance value. Why does that not trigger a tax charge? It seems to me that the answer, in the United Kingdom at least, is because it is, as I have said, a commercial transaction between the bank's subsidiary and the purchaser: commercial transactions have been expressly exempted ever since inheritance tax came into existence.

The language of the Fortress Trust looks at first sight a bit like that of the usual kind of discretionary settlement – a beneficiary may get something in the distant future, but he does not really know what. But the power structure is very different: in a discretionary settlement, the settlor is paying the money, and he confers on the trustee whatever power he chooses. But here, the beneficiaries are paying the money, and they are going to want the power to appoint and dismiss the trustee and make changes to the provisions of the trust deed. The Fortress Trust is in a way more like a company than a trust – the trustee playing the role of the directors, controlling and managing the investment portfolio, and the beneficiaries playing the role of the shareholders, with the power to hire and fire members of the board and to make changes to the memorandum and articles. You could say that the settlement is more an aristocratic vehicle: the one at the top graciously bestowing gifts gratefully received by the underlings. Whereas the Fortress Trust is an essentially bourgeois vehicle: the power and the benefit are in the same hands. I venture to think that this is more or in keeping with our times. By way of example, let me indulge myself with a little reminiscence. In this story, the late and lamented husband had left a considerable fortune on discretionary trusts for his widow and children. The trustee, who shall remain anonymous, but I shall call NatWest for easy reference, had a discretion how much to distribute and how much to accumulate, and was entitled to an annual fee equal to – I think it was – ½ % of the value of the trust fund. The discerning manager saw that the less he distributed and the more he accumulated, the larger the annual fee would be, and the larger his bonus would be. And when I came on the scene, the widow was selling pictures off the walls to pay for the groceries! This is of course an extreme case, but I think there are many cases where beneficiaries of trusts drafted decades ago wish they had power to update the provisions of the trust deed, as they could have done, of course if the trust had been in the form of the Fortress Trust.

My third New Trust is the Managed Investment Platform. The Fortress Trust is for investors interested in security and accumulation of income and gains. It may, as I said, accommodate non-cash benefits to family members, but it is not a machine for providing beneficiaries with spending money. The Management Investment Platform *is*: it is for investors who are happy to accumulate income and gains but also want to be able from time to time to draw out some tax-free spending money. Here it is in diagram form.



As before, the first steps take place offshore. The bank has lent its subsidiary £10m. The subsidiary has settled £10m plus the shares in X Ltd on trust to accumulate the income for 25 years, and subject thereto to pay the income to X Ltd for six months and subject thereto for itself absolutely. If the subsidiary does not wish to wait 25 ½ years for the reversion to fall in, it can from time to time sell a fraction of its entitlement to the reversion to a local purchaser, who can surrender it to the trustee for a price equal to the same fraction of the £10m.

Enter now the onshore investor, Mr Smith, who buys the reversion from the subsidiary. Mr Smith is now the holder of the reversion, and the trust looks like this.

TRUSTEE
£10M + X LTD

ACCUMULATE INCOME FOR 25 YEARS

INCOME TO X LTD FOR SIX MONTHS

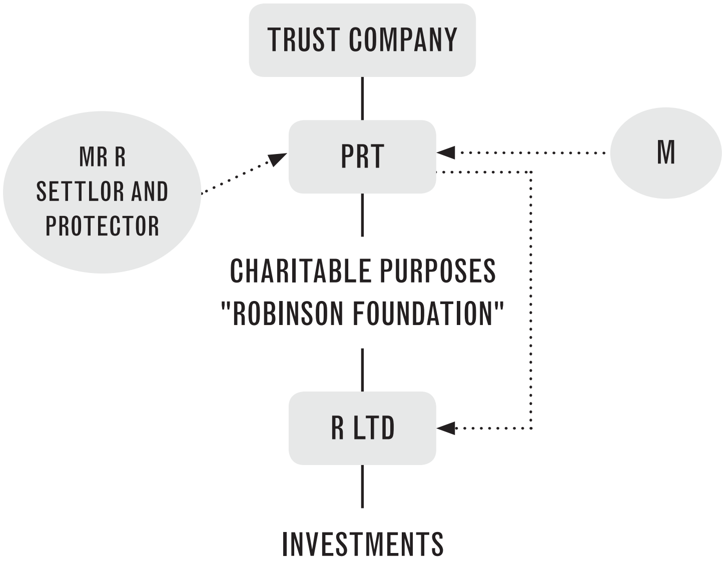
REVERSION TO MR SMITH

Like the Fortress Trust, the Managed Investment Platform is another off-the-peg suit, which will need some further tailoring to fit Mr Smith – the appointment of a new investment adviser, a protector maybe, and so on. If he does nothing further, the fund will accumulate its income and retain its capital gains for 25 years free of any tax except withholding tax, and then the trust fund, after paying its income to X Ltd for a further six months, will become the property of Mr Smith. In the United Kingdom, the vesting of the assets in Mr Smith will be treated as a disposal by him of his interest in reversion in exchange for possession of the trust assets, and he will pay capital gains tax on his gain. I guess much the same is true in other countries. The tax Mr Smith pays at the end of the 25-year period is in effect the tax he did not pay on the income and gains accumulated year by year, but there is of course no credit for withholding taxes. He has had the benefit of 25 years' tax postponement – and, more importantly, the trustee has been able during that period to sell successful investments and re-invest the whole of the sale proceeds without making provision for capital gains tax, a feature which adds quite considerably to the growth potential of an investment portfolio. If at any time during the 25½ years he needs spending money, he can sell to the bank a percentage of the reversion for a price equal to the same percentage of the £10m and the bank can surrender that percentage to the trustee for the same sum. Suppose he paid a 5% premium – paying £10.5m for the reversion to a fund of £10m, then 10% of the reversion will have a base cost of £1.05. He now sells this 10% of the reversion to the bank. The bank will pay him £1m on the sale. It can then surrender the 10% to the trustee for £1m. No doubt the bank will make a small charge for this facility, but Mr Smith will have no capital gain, and therefore no capital gains tax liability. On the contrary, he will have a loss reflecting the premium he paid on the purchase of the reversion.

If Mr Smith limits the percentage of the reversion sold to the value of the income accumulated and capital gains made, he will continue to have a fund of £10m. Suppose the trust fund is invested to yield a net 4% a year, and Mr Smith makes no surrender for three years. He may then sell to the bank his right to surrender 12% of the reversion. The bank pays him £1.2 million and receives £1.2 million on the surrender. In that case, the £1.2m which has come into the trust fund from the investments will be balanced by the £1.2m going out of the trust fund to the bank. If this pattern is repeated, the trust fund will remain stable at £10m. But the base cost of the remaining percentages of the reversions will go lower, giving rise to a potential capital gains tax charge – on these figures – from year 21 onwards, by which time anything can happen – there may no longer be a capital gains tax or Mr Smith may no longer be living in the United Kingdom, or at all. I betray in my last sentence the truth behind the Managed Investment Platform – that I thought of it from the beginning in terms of a purchaser who is subject to UK tax. Staying with the UK aspect just for the moment, I think the reversion is an item of a capital nature, and, as I have said, no tax arises on the disposal of parts of it. There is no "settlement" in a tax sense. And, as with the Joneses, no s.720 liability. Whether the tax result of investment in a managed investment platform is favourable to investors resident in other countries, leave for my readers to decide.

Which brings me to my last trust, the "Sky-hook" trust. This is my rather demotic term for an offshore trust which makes money for its beneficiaries by doing business with onshore customers. These will generally be customers with some kind of family tie to the trust, but who are not beneficiaries. The "sky-hook" trust can take many forms, but the example I am going to take is the offshore foundation which issues offshore bonds - just to family members. It makes money for charity, but it uses its offshore zero-tax status to benefit onshore bondholders. The offshore bond is not, of course, a "bond" at all: it is the name given to a single-premium endowment policy. It is essentially a savings vehicle with a small amount of life cover. The tax treatment of the bondholder is often very lenient, and nowhere is this more true that in the United Kingdom. Indeed, its promise of zero-tax accumulation and 20 years' non-taxable drawdown, with the blessing of the Her Majesty's Revenue and no hint of social disapproval, is – when you come to think about it – fairly amazing. But there are practical drawbacks. As with all insurance contracts, you only get your money if the insurance company is honest and solvent. Which means that you will probably want to do business only with the Big Brands. Big Brands are conservative investors: understandably, they are not going to put money into any investment they cannot liquidate. And Big Brands charge big fees – and need to because they have big expenses – not least in the form of commissions they pay to salesmen. So why not have one's own private offshore insurance company, issuing bonds only to family and friends? Most people think you need a large issued capital for an insurance company, and a staff of actuaries and others to administer the business. But that is not true. An offshore bond or other endowment policy is essentially a managed portfolio coupled with life insurance. You can buy–in portfolio management, and you can go into the market and buy–in some life cover, and Hey Presto you are in the life insurance business.

But not quite. In any offshore centre you would want to use, a licence is required to do life insurance business. And I am afraid the government official whose job it is to give or withhold a licence is going to take the same view as the view I attribute to "most people" – that you need a big issued capital and skilled staff. So, is the private offshore insurance company strictly for multi-millionaires only, or is there a solution to this problem? This is where the "Sky-hook" trust comes into the picture. I start with the basic proposition that if I issue policies – or do anything else – without any intention of making a profit, and in the event actually make no profit, I am not carrying on a business. And I do not think it matters if someone else benefits, so long as I do not benefit myself. Picture then, the "Sky-hook" trust which issues the policies and makes no profit, but has a wholly-owned subsidiary which re-insures the liabilities arising under the policy and makes a profit doing so.



Mr Robinson, on the left, creates a charitable trust with a private trust company ("PRT"), which belongs to a major trust company in an offshore jurisdiction. In the self-effacing way so many benefactors have, he calls it the "Robinson Foundation". It has a subsidiary, which I have labelled "R Ltd". His daughter Mary, whom I show on the right, takes out the policy with PRT acting in its capacity as trustee of the Robinson Foundation and pays the premium to PRT, which in turn pays the premium money to R Ltd in return for an undertaking by R Ltd to meet all liabilities arising under the policy. R Ltd buys in the necessary investment expertise and life cover. It is probably located in the same offshore jurisdiction as the private trust company, but it may be located in a treaty jurisdiction if the nature of the investments makes that desirable. The taxable profits of R Ltd will be only a small fraction of the income from the investments, and if the company is going to be located in a jurisdiction with a serious tax rate, it will of course be important to negotiate ahead of time a deal with the local tax authorities that the growth of R Ltd's liability to the PRT will be deductible in computing its profits.

But I stray from my main theme, which is that an offshore trust can serve as a "hook" to hang other assets, with beneficial results. Practitioners from the United Kingdom may notice that this policy is not a Personal Portfolio Bond: Mary cannot influence the choice of investments backing the policy. But her father is protector of the foundation, and in practice a trustee is always going to do what the protector wants, which means that the investments backing Mary's policy can include unquoted shares, jewellery, property and so on, which an insurance policy could not contemplate. And it is certainly a good deal cheaper than the offshore bond available in the market. There will in most countries be a charge to tax when the policy matures. The UK investor may take out the policy as the trustee of a "Thin Trust" – ie., a trust primarily for his own benefit, so that what he has to sell at the end of the day is an interest under a trust.

So these are my four New Trusts. It seems to me that the tax effect of each of them is wholly benign. But can it be said that any of them constitutes "tax avoidance", in the sense that the application of some general anti-avoidance rule could alter the tax result? I am, of course, really only qualified to answer this question as far as they affect UK taxpayers, but a few general observations may be useful. Let me go back to the Twin Trust. On the face of it, everything the beneficiaries get is of a capital nature. But is there some way an anti-avoidance rule could be invoked, to say that what they get is really income and should be taxed as such? I do not see any scope for that. The appearance is the reality: the sums they get are actually capital, and in the United Kingdom at least would not be subject to tax.

Let us now look again at the Fortress Trust.

This has more of an avoidance "feel". The estates of all three Joneses have been reduced in value, because the interests they have bought have – taken separately – very little value, even though all of them – taken together – are worth £10 m. Reducing the value of your estate is generally the occasion for a charge to inheritance tax, but here it is just a by-product of a commercial transaction in each case, and – in the United Kingdom at least – commercial transactions are expressly taken out of the class of chargeable dispositions by statute. So now the question becomes, 'Can a general anti-avoidance rule override the statutory rule and impose a charge to inheritance tax?' It might be argued that the Joneses could create a structure like this on their own, and save money by not paying a premium to the bank. Let me call that the Economy Route. Many countries have rules which penalise taxpayers who create foreign trusts, and if the Joneses were domiciled and resident in the United Kingdom, they would run into a thicket of tax liabilities. So, it could be argued, they are avoiding those taxes by doing a commercial deal with a bank instead. I'll call that the Bank Route. The argument would be that the Economy Route and the Bank Route lead to the same destination, and if the Joneses choose the Bank Route because it costs less tax, what they are doing is indeed tax avoidance. The trouble with that argument in this case is that the Economy Route and the Bank Route do not lead to the same destination, and the difference lies in the asset protection, which the Bank Route provides and Economy Route does not. Many countries have laws whose effect is that a gift can, in circumstances which vary widely from one jurisdiction to another be undone, but a commercial transaction cannot. If the Mr, Mrs or Miss Jones who took the Economy Route becomes bankrupt, their trustee in bankruptcy may have access to the trust fund to recover the settlor's contribution. But if the Jones purchaser in the Bank Route becomes insolvent, the trustee in bankruptcy will have no access to the trust fund. He may take possession of the trust interest the bankrupt bought, but will soon discover that it has no value except nuisance value and will be responsive to more or less any offer from other members of the family to buy it back from him.

Now to the Managed Investment Platform, which also has an avoidance 'feel'. Mr Smith can get spending money every year, and yet he will say that he is not receiving income. Well, actually, that is true: he is not receiving income; he is getting back the capital he spent. So can a general anti-avoidance rule treat the money he gets as income? UK taxpayers are undoubtedly helped here by the provisions which treat draw-downs from what are called "offshore bonds" as returns of capital. But I think the real question we have to ask, "Is the money Mr Smith gets from periodical sales of part of his interest in reversion *really* capital, or is it income in disguise?" If it is income in disguise, then an anti-avoidance rule will operate to treat it as income. But it seems to me plainly capital: what Mr Smith does is assign a future right to capital in exchange for cash now. How can the consideration he receives be anything other than capital?

And lastly, in this context, let me go back to the Sky-Hook Policy. Mary Robinson doesn't really get any tax advantage not available to any other policy holder. What she essentially gets is a wider range of investments supporting her policy than the commercial insurer would allow. I have mentioned yachts and Caribbean islands in this context, but perhaps the most interesting use of such a policy is for investment in the unquoted company destined to come to the market in due course. But Mary also enjoys an advantage not enjoyed by beneficiaries of trusts, and that is in the field of registration. The Robinson Foundation may require to be registered and its existence known to the public. But there are no public registers of beneficial owners of insurance policies – which is in a way rather odd, because an insurance policy is just as much a container of wealth as a company or a trust. The insurance industry, however, is a powerful lobby, and I would expect any proposal to create a register of policy-holders to meet very stiff oppositions. The irony of the Sky-hook policy structure, from a disclosure point of view, is that the unimportant part is disclosable and the important part is not.

Appendix

The technical point is that the "transfer of assets" made by the Joneses – the payment of the purchase price of the interest, made to the Subsidiary in each case – does not cause any identifiable income to be paid to anybody. If it is argued that the relevant transfer was from the bank to the subsidiaries, then the answer is that no UK taxpayers were involved or in contemplation. (The purchasers might come from anywhere.) In any event, the Joneses are not "transferors" in relation to that transfer. But the substantial point is the one made in the text: no tax is avoided.