

THE OFFSHORE TRUST

Milton Grundy¹

Settlements with trustees resident in a low-tax or zero-tax jurisdiction have become known as Offshore Trusts. I say “become known as” because I believe I actually coined the phrase, using it as a title for an article in the British Tax Review in 1971². It looks rather quaint now to see that in my article I spelled “off-shore” as two words, with a hyphen in between. In those days the subject – like the expression – was quite a new one. A trust in, say, Bermuda or the Bahamas could be thought of simply as an English trust in a warmer climate: it could accumulate income throughout the perpetuity period, but did not otherwise depart from the English model. But already the Offshore Trust was beginning to develop a life of its own. This has manifested itself in four ways – the legislatures in offshore jurisdictions³ have embraced statutory modification to their trust law as a branch of marketing; a number of drafting practices have evolved which have no parallel in onshore trust instruments; the litigation explosion which has resulted from the huge success of the offshore trust concept has yielded many pages of judicial decision, some of which have thrown a good deal of light into dark corners of the subject; and the offshore jurisdictions have found a need to regulate the offshore trust business.

Legislation

An early straw in the wind was the enactment of the Cayman Trusts Law of 1967. In principle, a trust confers certain rights on its beneficiaries even though they are not parties to the contract and give no consideration for the benefit they enjoy. The Cayman Trusts Law provided an exception to this principle in the form of the Exempted Trust. This made it possible⁴ for a settlor to create an

1 Milton Grundy MA (Cantab). FTII. The writer is head of Gray’s Inn Tax Chambers and President of the International Tax Planning Association. This article is adapted from a talk given to the Association at its meeting in Hong Kong in November 1999.

2 1971 BTR 336.

3 *Pace* Charles Cain 8 OTR 209 at p.219.

4 By following the procedure set out in s.79.

offshore trust, under which no beneficiary has any right to enforce the trust, whether he has a vested or contingent interest, or merely an expectancy as the object of a power or discretion. The trustees may be sued for breach of trust only by successor trustees or by the Registrar of Trusts. No beneficiary is entitled to any information or to inspect or copy documents. There was a short period⁵ when this kind of Exempted Trust could confer a tax advantage on UK residents and a rather longer period when it has done the same for Canadians, but the practical importance of these provisions is that they enable a settlor to confer benefits on children or on adult beneficiaries of unsound mind or weak personality or on individuals he thinks may turn out to be greedy or grasping, without giving them any right to apply to the court or otherwise make nuisances of themselves.

The area in which legislative change has been used most aggressively as a marketing tool is that of Asset Protection Trusts. My article in the *British Tax Review* has a footnote which reads –

“Theoretically, one may suppose, an off-shore trust might be effective to frustrate the legitimate claims of a creditor or divorced spouse, though the writer has never personally come across such a case”.

Well, that was 1971, and the reader may think that I had led a very protected life. Nowadays, I have a perhaps rather undeserved reputation for being an expert in this area, because I am a joint author of a book on this subject, whose first edition was published in 1990⁶. The truth is that I have never actually settled a draft Asset Protection Trust. I have talked to clients who thought they might like to do one. And I have had joint conferences with bankruptcy counsel – the law in this area having essentially more to do with insolvency than with trusts or tax, but I have never been able to advise a client to go ahead. The problem here is that by the time the client has got to the point of talking to counsel about protecting his assets, it is generally too late. Of course, I have put clauses in a draft trust instrument which would afford a measure of asset protection should the need arise. But this can be effective only if there is nothing on the settlor's horizon which suggests, at the time when he makes the settlement, that Asset Protection is needed. And in this context, I do not think it matters what the law provides in the offshore jurisdiction concerned – whether it is very pro-beneficiary, as in the Cook Islands⁷, or more even-handed, as the draftsmen would claim for the law in

⁵ Which came to an end with the passing of the Finance Act 1969.

⁶ *Asset Protection Trusts*, by the writer with John Briggs and Joseph Field (Key Haven Publications PLC, third edition 1997).

⁷ International Trusts Act, 1984 (as amended).

Belize.⁸ What really matters here is the remedies to which an aggrieved creditor may have access, and no professional adviser in his right mind is going to plan to be a defendant in an action for conspiracy, however large the fee might be.

Another legislative initiative has been to lengthen the perpetuity period by statutory provision. In the absence of such statutory provision, it is usual in the British Commonwealth to follow the English practice of defining the perpetuity period by reference to the lives of the descendants of a recently deceased monarch. Statutes in some jurisdictions provide for the duration of a trust simply as a number of years. Bermuda⁹ has adopted the 100-year period provided in the Cayman Law of 1967; Belize¹⁰ permits 120 years, as do the Cayman Islands nowadays. Anguilla¹¹ has boldly – some say rather incautiously – abolished the concept altogether.

Drafting Practices

There are some features which are found in offshore trusts which do not derive from any facilitating enactment, but have been developed by practitioners in the offshore world and are not commonly encountered onshore. Three are of particular interest – the trust for the benefit of the settlor, the power to change the law of the trust and the place in which it is administered, and a provision establishing the office of Protector.

The trust for the benefit of the settlor is what I have sometimes called the Thin Trust. Typically, this is a trust for the settlor for life and subject thereto as he may appoint. It is “thin” by analogy with the American expression, “thin capitalisation” – where the company’s equity is real but not very important. A “thin trust” is a real trust, but the economic dominion over the trust fund remains with the settlor.

The Thin Trust was developed as an offshore vehicle for the settlor who is resident in the United Kingdom but not domiciled there. If he holds his foreign investments directly, he is of course liable for capital gains tax on so much of his gains as he remits to the United Kingdom. What is really tiresome about this liability is not so much the tax he has to pay, but the cost of ascertaining how much it comes to. First of all, somebody has to calculate the gains he has made,

8 Trusts Act 1992, drafted by the writer, with Philip Baker.

9 Perpetuities and Accumulations Act, 1989 (as amended).

10 Trusts Law 1992.

11 Trusts Ordinance 1994, s.6.

and with any kind of active portfolio this is going to be quite a task. Then there has to be ascertained what happened to the gains and how much of them was remitted. As a result, many a non-domiciled individual finds that his foreign investment fund is for practical purposes unremittable. The Thin Trust overcomes this problem: the trust has gains but no remittances; the client has remittances but no gains.

The Thin Trust is useful also in structures which use a trust to obtain tax treaty relief for capital gains. In a typical case, the client in Kuwait wants to make a direct investment in Spain, but does not want to pay Spanish tax on the gain he expects to make when he disposes of the asset. He creates a Thin Trust in the United Kingdom, with a UK company as the trustee and himself as the income beneficiary. There will be no question of any treaty relief on the dividends paid by the Spanish company because the income does not belong to the UK company. But capital gains are different. A gain on capital account augments the trust fund; it belongs to the trustee and not to any beneficiary. If the trustee is a resident of the United Kingdom – and in many of the UK treaties it is sufficient that the trustee is a company incorporated in the United Kingdom – then, it is submitted, the trust company is entitled to the benefit of the capital gains article in the treaty. The combination of the domestic exemption for trusts made by non-resident settlors¹² and the wide range of treaties to which the United Kingdom is party makes the UK Thin Trust a very useful investment vehicle. Ireland offers a similar domestic exemption, and it is a feature of both countries that the foreign income of the Thin Trust will not be taxed, so long as the beneficiary is non-resident. It is not taxed for the same reason that it is not entitled to relief under a treaty: it does not belong to the trustee, but – in my example – to the Kuwaiti settlor/beneficiary.

There is now a wide choice of host countries for an offshore trust, but in assessing the relative political merits of these by now highly competitive territories, it is probably not possible, in the present state of the world, to attempt a long-term view, and it is in recognition of this that the trust instrument will generally contain a mechanism whereby a person not subject to the jurisdiction of the host country has power to change the trustees or otherwise remove the trust from that jurisdiction. A good deal of drafting ingenuity has been devoted to perfecting a form of “triggering clause”, so that the place of administration is changed upon the happening of certain events. I myself have never seen a draft which I regard as wholly satisfactory; whether the emergency is of such a nature as to require the removal of trusts from a territory may be a matter for nice judgment in a particular case, and it seems to me a better practice to appoint an individual or a committee to make this judgment, rather than to attempt an

impersonal mechanism to effect the change. Some draftsmen include a provision enabling the person outside the host country to change the law governing the trust. Again, I have never seen a provision to this effect which is entirely free from problems. Certainly the power should not be wide enough to permit a purported change of law from one which recognises trusts to one which does not. But even if that point is taken care of, the provision may not protect the trust assets against, say, the dictator who comes to power in the host jurisdiction and changes the law so as to impose heavy taxes on trust assets: one change the dictator could introduce would be one invalidating any such provision in a trust instrument. But when it is the trustees - rather than simply the place or the law - who are to be changed, the important effect to be achieved is that the trust assets should be capable of being dealt with by the successor trustees in the manner which the trust instrument originally envisaged, and that the person actually having control of the title deeds or share certificates or bullion, or whatever the trust assets consist of, can be relied upon to recognise the title of the new trustees quickly and without argument.

One function of the Protector can be to make necessary changes in the event of such an emergency. But the general function of the Protector is to act as a kind of liaison officer between the trustees and the beneficiaries. What exactly the Protector has power to do depends, of course, on what the trust instrument provides. My practice is to give the Protector power to change the trustees and to change the jurisdiction in which the trust is administered. But there are no fixed rules about this. Some draftsmen give the Protector a veto over acquisitions and disposals of investments by the trustees, and I have seen trust instruments which empower the Protector to add and even remove beneficiaries, and some which enable the Protector to charge for his services. But in practice the crucial power is the power to change the trustee. If I had been writing this article as recently as this time last year, I would have said that a power to dismiss a trustee is one which the Protector never needs to exercise, at least in a case where there is a charging clause in the trust instrument, because a trustee would rather comply with the Protector's wishes than get the sack. But I now know that a trustee who does not want to go can put up quite a fight, and that the person who bears the burden of conducting the fight is of course the Protector. When I say "burden" I mean the energy and all the anxieties attendant upon litigation - not forgetting, of course, the question of 'Who is paying for all this?'

Another burden which descends upon the shoulders of the Protector is that of dealing fairly with the beneficiaries. Take the typical case of the accumulating and discretionary trust for the benefit of the settlor's children and remoter issue. While the settlor is alive, the Protector can always consult him about family problems - and indeed it is generally the understanding between the settlor and

the person he appoints as Protector that this is exactly what will happen. But move on a few years. The settlor is dead and his wife has not survived him. The children are grown up and there are grandchildren of various ages. The Protector knows that what was in the settlor's mind was that the trust fund should be a "rainy day" fund – that the money and assets in the fund were not meant to provide his children with Maseratis and houses in the South of France, but were there to shelter his descendants from disasters – as it might be a Lloyd's membership, a serious ailment, a dishonest spouse. Now the Protector finds the children of the settlor thinking they should send their children to Eton and that the trust fund is to pay for it. What is the Protector to do?

The first answer is that the Protector does not have to do anything. But if he decides to do something – like approve a distribution by the trustees of some money to some beneficiary, he is at liberty to do so. Not only do the beneficiaries look to the Protector to ensure that all claimants to the income and capital of the trust fund are dealt with fairly, but the offshore trustee – who will typically have no personal knowledge of the affairs of the beneficiaries – will, in a perfect world at least, look to the Protector for accurate and disinterested advice for their administration of the trust fund.

Disinterested advice?

I recently came across a case where the Protector is a much-respected lawyer in his late fifties, and one of the beneficiaries is a girl who has grown to be a very attractive young woman. The other beneficiaries have discovered that the attractive young woman and the Protector are living together in a house neither of them could afford. It is my view – and if any reader can give me any authority to support it, I hope he will let me know – that one cannot be a Protector of the trust and at the same time the lover of one of the beneficiaries. The trustee is entitled to expect that advice he gets from the Protector will be disinterested, and it is the duty of the Protector – insofar as he gives advice at all – to give advice even-handedly as between the beneficiaries. His relationship with one of them disqualifies him from acting, and if he does not resign, the Court will make him do so.

The Litigation Explosion

In the 60's and 70's, trust companies were mainly occupied in bringing new settlements into existence and in that world of telexes and snowpake the archetypal settlor was the rough-diamond entrepreneur, who settled \$10,000

knowing that he could turn it into much more and instructing his trustees to look after his widow and descendants. Often, he did indeed turn it into much more, and very often he worked himself into a premature grave in the process. And now, hardly is his body cold, but the grieving widow is buying speed boats for young lovers and the children are leveraging themselves, at some considerable expense, several notches up the social scale. There are, of course, cases whose history is more edifying, but one way or another the dominant *persona* in the world of offshore trusts is no longer the settlor, and trustees are having to deal with claimants of all kinds.

To read through the cases¹³ on the subject is a sobering experience. When you appreciate what mayhem can be created by a creditor of the settlor, or an aggrieved widow or other legal heir, or by a greedy Protector or dissatisfied beneficiary; when you look at what can be done by a claimant seeking information or rectification of a trust instrument, or alleging a sham, or negligence, or improper investment or the existence of a constructive trust; when you read about applications to the court to grant a *Mareva* injunction (or freezing order) or to order discovery (or disclosure) or to award costs; when you see dissatisfied beneficiaries pursuing remedies not only against a corporate trustee but also against its directors, or disputing the validity of a change of trustee; when you see how the judgments bristle with difficult issues of law - issues relating to duties of skill and care, prudence and diligence, to unjust enrichment, to tracing and to periods of limitation; when you find the court wrestling with problems of negligence and gross negligence and equitable fraud; when you contemplate the time and the energy and the anxiety involved - to say nothing of the cost, you may think that the offshore trust business is not for the fainthearted. Twenty or thirty years ago, when most business was new business, it may not have been so. The duties of the trustee were not onerous: what he basically had to do was to make sure he did not lose the share certificates. But since that time companies have floated or been sold and settlors have died. And now a trustee will find himself with an investment portfolio of some considerable size and all the duties that entails - choosing the right investment advisers and monitoring their performance, and organising the accounting and administration that goes with it. And the person in his waiting room is not a wealth-creator wanting to make provision for his successors, but the beneficiary of a trust set up some time ago, who has come to get his hands on the money in the fund under the trustee's administration - and maybe on a bit of the trustee's money too, on the grounds of his failure to administer it better than he did.

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The relevant passages from the judgments are assembled, with commentaries, in the writer's *Trust Casebook* (ITPA 1998).

The case which, more than any other, has sent tremors throughout the offshore world is *Rahman*.¹⁴ It was decided by the Royal Court in Jersey. Much of the judgment was taken up with a discussion of a maxim of Norman French law now merely of historical interest. The aspect of the decision which is of continuing interest is the finding that Mr. Rahman's purported settlement was a sham. In some respects the judgment was undoubtedly salutary. There were probably more offshore trustees doing unquestioningly what "the client" told them than any of them would like to admit. But the effect of the decision seems to have been to send the average trust officer running for cover any time the settlor has anything to do with the trust fund. I recall a case of an individual who had spent the last ten years investing on the stock exchanges. He believed in taking a small profit, but taking it often. And by dint of such active trading he had turned a few thousand pounds into a few million. All his investments were held by an offshore company, of which he was managing director and his wife his co-director. He was not resident in the United Kingdom or any country where such a structure would give him tax problems. For reasons quite unconnected with his investment business, he wanted to make a settlement, and a draft was sent to the managing director of an offshore trust company for his approval. The managing director approved the draft, but would only execute the trust instrument if he could at the same time change the directors of the offshore company, replacing the settlor and his wife with members of his staff. The settlor did not think that any trust officer was going to have quite his success in the stock market. But the managing director believed that *Rahman* required him to exclude the settlor from management of the company's business. When I gave the talk on which this article is based, I was amazed how many trust officers in the audience thought that the managing director was quite right!

Regulation

There is one very significant respect in which I have noticed a change in the offshore trust business, and that is the increasing requirement for regulation. I am not thinking here of precautions against money-laundering – which have had a number of effects, not least an increase in the cost of running a trust company, but more of the requirement for a licence or other form of government permission for the operation of a trust company. This is now so accepted, that it is almost embarrassing these days to recall occasions in the past when an offshore trust company could be established, without the need for any licence, and with an issued capital of £2 divided into two shares of £1 each. Such a thing is of course now unthinkable in virtually any offshore jurisdiction (unless one counts the

¹⁴ *Rahman v Chase Bank*, 1991 JLR 103.

United Kingdom as “offshore”).¹⁵ People who are in favour of licences always tell us that they are necessary in order to protect the public – even though it is quite apparent that the granting of licences is quite a good way of raising revenue for government. But what is, perhaps, not quite so apparent is the way that the power for a government to grant – or withhold – a licence is a power for government to enforce its policies, whether its policies have been made clear to the public or not. If what a jurisdiction wants to do is to make sure that its trust companies are directly or indirectly owned by large international banks, a licensing system is a very good way of separating those it wants from those it does not want. And I suspect that there has been in recent years quite a lot of disguised pressure in many offshore jurisdictions to get rid of the little guy: his company is dismissively referred to as a “one man and his dog” company. I am not at all sure that getting rid of the man and the dog is a good idea. It may be very romantic of me to say so, but once upon a time there was some little guy in a garage just down the road who was inventing something which he called a jet engine. What a mistake it would be to impose a licensing requirement on little guys in garages, with a view to transferring their business to Multi-Garage plc. It seems to me that the interests of the consumer are best served if he has a choice between the “large” company – which may be owned by a bank of international standing, and the “small” trust company, which will characteristically be owned by one or more individuals. The “largeness” and “smallness” of these companies will generally be reflected in their share capital, volume of business, number of employees and size of premises occupied. There are advantages and disadvantages of both kinds of corporate trustee: the client of the large trust company will have some sense of reassurance that his assets will be handled by a company of some substance, so that if they were lost, by the incompetence or dishonesty of one of the trust officers, he could confidently look to the company or its parent to make good the loss. Inevitably, the large company is not able to offer the kind of personal service available to the smaller organisation: personnel may move from one part of the group to another in the course of their careers and the client cannot expect the kind of continuity he would take for granted with a small company. On the other hand, his protection against a loss of assets by any act or default on behalf of a small company will be related more to the client’s confidence in the individuals occupying senior positions and the systems they have instituted, than to the share capital or assets of the company, though a prudent client will nevertheless satisfy himself that the amount of professional indemnity cover enjoyed by the company is satisfactory.

¹⁵ See Charles Cain, *ibid* at pages 217-8.