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A Basic Guide to Selecting a Trust Jurisdiction

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In a recent article, the authors discussed the rationale, benefits, and important considerations involved in cross-border wealth structuring. Trusts are often used in this process for asset protection, tax optimization, succession planning, and wealth management, and it is important to select an appropriate trustee, jurisdiction, and trust law. This article discusses some of the options and important considerations.

Offshore v. Onshore

An offshore jurisdiction typically refers to countries or territories that offer tax benefits, privacy, and regulatory advantages to foreign investors and businesses. These jurisdictions are often characterized by low or zero tax rates on trust and corporate profits, capital gains, and income, as well as enhanced confidentiality for the identities of business owners and investors. Offshore financial centers are popular for setting up companies, trusts, foundations, and other legal structures to optimize tax liabilities, protect assets, and facilitate international financial transactions. Examples of offshore jurisdictions include the British Virgin Islands, Cayman Islands, Bermuda, Luxembourg, Isle of Man, Bahamas, Jersey, Guernsey, Panama, Liechtenstein, Cook Islands, Nevis, and Gibraltar.

Using an offshore jurisdiction can offer several potential benefits, including tax optimization, where businesses and individuals can reduce the risks of double taxation. It also may provide enhanced privacy and asset protection, safeguarding assets from threats in one's home country. Offshore jurisdictions can facilitate foreign direct investment and international trade, with simplified reporting requirements and regulatory environments designed to attract, pool, and deploy capital. Additionally, they can offer political and economic stability to capital from more volatile regions.

Some risks and disadvantages of using an offshore jurisdiction include potential legal and reputational risks associated with perceptions of tax evasion, fraudulent conveyances, or unethical financial practices. There can be increased scrutiny from tax authorities and international regulatory bodies, leading to complex compliance requirements and customer due diligence. Offshore jurisdictions might also face political or economic instability, affecting the safety of assets. Additionally, less transparency and regulatory oversight can increase the risk of fraud and financial crime.

An *onshore* jurisdiction typically refers to countries that impose conventional tax rates on business profits, income, and capital gains, and have stringent regulatory and compliance frameworks. These jurisdictions are known for their transparency, adherence to international financial regulations, and robust legal systems. Onshore jurisdictions may offer less privacy in financial matters but provide greater stability and recognition in the global financial system, making them suitable for operating and/or regulated businesses, and individuals seeking to maintain a transparent and reputable financial presence. Examples of onshore jurisdictions include the United States, the United Kingdom, Germany, France, Australia, Canada, Japan, and South Korea.

Global efforts to level the regulatory playing field

Arguably, the distinction between onshore and offshore jurisdictions has always been blurred and is becoming less relevant. For decades many onshore jurisdictions (such as the City of London) have offered offshore type features and services to attract capital and stimulate economic activity. More recently, global efforts towards financial transparency and anti-money laundering (AML) and counter-financing of terrorism (CFT) regulations have levelled the playing field.

The Financial Account Tax Compliance Act (FATCA), the Common Reporting Standard (CRS), the Base Erosion and Profit Shifting (BEPS) project, and Registers of Beneficial Ownership have pushed jurisdictions traditionally considered 'offshore' to adopt standards similar to those of 'onshore' jurisdictions. Consequently, the global financial landscape is evolving towards a more uniform regulatory and compliance framework, diminishing the obvious contrasts previously seen between finance centers.

Despite global efforts to level the regulatory playing field, there remains an illogical and often unwarranted stigma associated with some offshore jurisdictions due to incidents such as the Panama Papers scandal. This prejudice often translates into practical challenges, particularly when entities established in these jurisdictions engage with regulated counterparties like banks. Financial institutions, under pressure to comply with international AML and CFT standards, may apply enhanced scrutiny or even refuse to deal with trusts and companies from offshore jurisdictions perceived as less transparent. This risk aversity can complicate banking relationships and financial transactions, impacting the operational efficiency of entities based in offshore jurisdictions.

The emergence of the mid-shore jurisdiction

A mid-shore jurisdiction is a less commonly used descriptor, but it has evolved as a term to describe a jurisdiction that combines the legal and financial advantages of offshore financial centers with the stability and regulatory framework of onshore jurisdictions. A mid-shore jurisdiction offers a balanced approach, providing tax efficiency and efficacy for international business and investment, while adhering to international standards and regulatory requirements. These features are attractive for families, businesses, and investors seeking to hold their wealth or optimize their operations within a legal and regulatory environment that is recognized and respected globally, bridging the gap between the traditional offshore and onshore models.

Examples of mid-shore jurisdictions include Hong Kong, Singapore, Ireland, Malta, the Netherlands, Luxembourg, the United Arab Emirates, and New Zealand.

Furthermore, within some federal jurisdictions there are states within a state whose laws are designed to attract domestic and foreign capital and business. Examples in the United States include South Dakota, Wyoming, Nevada, and Delaware.

Each jurisdiction is unique in terms of how income and capital is taxed, reputation, privacy, regulation, compliance, sophistication of the local finance industry, and law. Geographic location, language, and culture may also be a relevant factor in attracting business.

Choice of law

The law governing a trust does not necessarily need to be that of the jurisdiction in which the trustee (or indeed the settlor or beneficiaries) is located.

Under the 1985 Hague Convention on the Law Applicable to Trusts and on their Recognition (Hague Convention), it is generally possible to select the law of a foreign jurisdiction to govern a trust in another jurisdiction. While the Hague Convention has only been ratified by 14 countries (including Australia, parts of Canada, Hong Kong, Switzerland and the United Kingdom plus 12 of its dependent territories/crown dependencies) the common law of most countries will have the same permissive effect, subject to public policy considerations.

This gives the flexibility to choose a governing law for a trust that provides the features that a settlor values most in a structuring strategy. For example, a settlor might want to select a jurisdiction that provides:

- "Firewall legislation" which is designed to insulate trusts against foreign claims against the trust, dispositions of property into the trust, or the capacity of the settlor.
- Wide powers of variation without requiring the consent of beneficiaries.
- Statutory provisions that permit certain decisions taken by trustees to be unwound where they had unintended (often tax) consequences.
- Protection to settlors from creditors' claims seeking to claw back transfers into trust.
- Protection to third parties dealing with the trust in good faith.
- Reserved powers legislation that confirm the express reservation of certain powers will not invalidate the trust.
- Mechanisms for trustees to hold shares in operating companies more expediently than under an orthodox discretionary trust.
- For trusts to be set up for non-charitable purposes and hybrid (purposes and persons) trusts.
- For trusts to exist in perpetuity or otherwise longer than traditionally permitted.
- Alternative dispute resolution (e.g., mediation and arbitration) procedures for the resolution of internal disputes.
- Flexibility in relation to the required disclosure of information about the trust to beneficiaries.

It is important to consider both the advantages and the disadvantages of a particular jurisdiction's trust laws before proceeding. No one jurisdiction provides a perfect solution.

The courts

While a robust legal framework is essential, the quality of a jurisdiction's court system is equally critical. The court is the ultimate supervisor of a trust, and several factors must be considered:

- **Credibility of the jurisdiction:** Any perception of bias, corruption, or incompetence within the judiciary can undermine the trust jurisdiction's credibility. A compromised judiciary erodes trust and confidence in the legal system, potentially jeopardizing the very purpose of establishing a trust.
- **Protection of beneficiaries:** The ability of the courts to scrutinize trustees is essential for maintaining trust integrity. Settlors and beneficiaries need confidence that trust assets are secure not just on paper, but in the practical application of legal scrutiny.
- **Ability to apply the law:** Judges' comprehension of trust law is fundamental. Clients rely on the courts to interpret and apply the law correctly, ensuring the protection of trust assets for the benefit of the beneficiaries. The court's experience in making sound legal decisions in trust-related matters is a key factor in selecting a jurisdiction.

History

Less established trust jurisdictions may pose uncertainties regarding the practical interpretation of their legislation. A paucity of historical precedent can introduce an element of risk to the trust's effectiveness.

Mature jurisdictions with a longstanding and regulated trust industry are generally predictable. The ability to assess the law, professional expertise, licensed institutional grade fiduciaries, and the courts' approach over decades provides certainty. Established jurisdictions with a robust track record instill confidence that their legal systems have withstood the test of time and have been reliable in protecting trust assets.

Service providers

The capabilities and experience of trustee companies are essential to the effective administration of trusts:

- **Trustee's litigation history:** A trustee's track record in navigating challenging litigation is important to their resilience and commitment to safeguarding trust assets. This history is a critical factor in assessing the trustee's reliability in adverse legal scenarios. The ability to weather legal storms and emerge with assets and reputation intact is indicative of a trustee's competence and dependability.
- **Network of legal contacts:** A trustee's network of legal contacts is a strategic asset. The ability to tap into diverse legal expertise around the world ensures the trustee can adeptly handle a spectrum of legal challenges, enhancing the overall effectiveness of the trust structure. A well-connected trustee is better equipped to navigate complex legal landscapes, providing an additional layer of security to the trust.
- **Experience in issue identification:** Identifying crucial issues is a skill that comes with experience. Trustees with a proven ability to navigate legal complexities and human dynamics and obtain expert accurate advice instil confidence. The capacity to identify and address potential legal challenges before they escalate is a hallmark of a proactive and capable trustee.
- **Competence:** Selecting a jurisdiction with a sophisticated and competent trustee industry will go a long way towards mitigating the risk of a legal claim against the trust. Trustees who do not follow international best practice are more likely to face claims in relation to their administration and governance of the trust.

Regulation and supervision of trustees

The regulatory environment plays a pivotal role in maintaining the integrity of a trust jurisdiction:

- **Licensing and regulatory framework:** A robust licensing and regulatory regime ensures that trustees undergo thorough due diligence checks and meet prudential standards. Scrutiny of ownership, personnel, fund protection policies, and other crucial factors is essential for upholding international standards. A well-regulated jurisdiction offers an added layer of confidence that trustees are subject to rigorous oversight, reducing the risk of malfeasance or mismanagement.
- **Variability in regulatory regimes:** Not all jurisdictions are created equal in terms of regulatory standards. While some jurisdictions have robust licensing requirements, others may have limited supervisory mechanisms. Understanding these variations is critical for evaluating the reliability of trustees. A comprehensive and effective regulatory framework is an important factor in jurisdictional selection .

A Design Led Process

In our view, contemporary wealth structuring requires sophistication and independence to avoid (at best) knowledge gaps and limiting biases and (at worst) conflicts of interest. This has led to the emergence of the role of the independent consultant who is jurisdictionally neutral and agnostic to fiduciary service providers and financial institutions involved in trust management.

Such a consultant does not necessarily replace the trusted advisors or jurisdiction experts and third party service providers, but becomes the architect of a design for an optimized platform to govern and administer the trust.

Once the design is finished the specific componentry can then be procured and assembled from the local/incumbent lawyers, tax advisors, trustees, wealth managers, and other vendors.

Conclusion

Legislation, court systems, historical context, trustee capabilities, and regulatory environments collectively shape the efficiency, effectiveness, and resilience of a trust jurisdiction. In our view, a holistic approach, coupled with expert independent consultation, is required to navigate the complexities of choosing a jurisdiction and setting up a trust.

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