

REASONS TO USE CHARITIES IN THE OFFSHORE WORLD

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Today this symposium is looking at charities from the perspective of them being useful investment and wealth planning tools. I have been asked to address the specific use of charities in the offshore world. The intent is not for me to discuss the charitable needs in the Cayman Islands and how the income earned in a Star Trust can be used to relieve poverty, advance education and convert the heathen. Instead my time will be devoted to exploring ways in which offshore charities can serve an investment and wealth planning agenda while accomplishing good in ways which are both legal, and consistent with the noble objectives of an altruistic philanthropist.

Where retaining personal capital is the primary objective of a person's wealth planning, offshore planning is usually chosen in preference to charitable planning. Once wealthholders have moved their capital offshore to a jurisdiction with minimal tax, most people assume there is no need for wealth planning to involve charity if a person's interest in philanthropy is driven primarily by a motivation to reduce tax.

However, my work as a charitable tax planner causes me to compete with offshore planners by pointing out the benefits of remaining in the community where the donor is respected by his peers for having made the money and may gain further respect and capital by donating large amounts to local charities. When the consequent tax savings are entered into an admittedly unscientific cost/benefit analysis with leaving family and friends for a distant country with no culture other than sunshine and complicated trust structures with expensive administration costs, frequently onshore charity is more attractive than offshore investing. There are clients who find that the inordinately high living costs in offshore jurisdictions are more expensive than paying tax on income in Canada.

The reality is that almost all tax incentives for donating to charity are limited to onshore charities. There are some exceptions to this in specific tax treaties such as the *Canada – United States Income Tax Convention*. It is also possible that the European Community may come to provide tax incentives for cross-border philanthropic giving. However, these exceptions seldom change the reality that people who can assuage their tax rage by donating to charity are not likely to go to the expense and complication of moving their wealth offshore into a jurisdiction which does not appeal to them as their permanent domicile and residence. In my experience the wife is apt to veto offshore tax planning found so alluring by the husband because of very practical family non-tax considerations.

In many wealth planning circles philanthropy is the new tax planning and there is little altruism in giving to charity. If the cost of losing wealth to a charity is much less than the cost of paying tax, then charity is an economically efficient option. In my opinion there is a correlation between the economic pain of giving and the altruism of the donor. If a donor is actually making money on an after-tax basis through sophisticated "buy-low give-high" schemes or even charitable annuity trusts which pay out levels of income which deplete all the capital, then the potential for abuse is high because a self-serving donor is not going to be concerned what the charity does with what little money it receives on a net basis.

Nevertheless, it is important to recognize that not all philanthropy which is blemished by a less than altruistic motivation is to be scorned or denigrated. Sometimes, philanthropy is the only reasonable option left to an entrepreneur with a philosophy that precludes giving too much wealth to children and an ideology that is opposed to paying taxes, especially estate taxes. Quite a few of my clients fit the profile of

Warren Buffet, unfortunately not with the magnitude of his wealth, who came to philanthropy as a last resort. The challenge advisors face is to educate such persons as to the best use of their money in the charitable sector.

Philanthropy is not only the new tax planning of our time. If implemented as the great white man's burden, philanthropy may also be the new religious zealotry of our time. It is important to recognize that huge fortunes transferred to charitable foundations have the potential to do harm as well as good. Many donors who give their fortunes to charitable foundations do so because they have come to believe, based upon a deep personal knowledge of their children, that their children can be trusted with only a fairly small amount of money for their own use. It is then somewhat contradictory to make these same children trustees of charitable foundations endowed with many millions of dollars and to give them a mandate to interfere in the lives of others in the name of "charity".

Other donors have a deep philosophical belief that their children should inherit only a fairly small amount of money for their own use so that they become productive self-supporting citizens rather than coupon clippers living off money they did not earn. As an advisor in such situations, it is sometimes difficult not to point out the similarity between this philosophy and the policy underlying the hated estate tax they are trying to avoid.

When considering the tax issues involved in dispositions of wealth, it is important to distinguish *inter-vivos* taxes and *inter-vivos* giving from estate taxes and testamentary giving. Frequently, jurisdictions with high gift and estate taxes, such as the United States, have lower income taxes. There are also important distinctions related to the availability of tax relief: for example, while US donors can only obtain a deduction from income tax if they donate to a charity resident within the US, they can obtain deductions from estate and gift taxes if they donate to non-resident charities. Consequently, when engaged in charitable gift planning it is important to recognize that a tax driven US donor might make all of her gifts to onshore charities during her lifetime but make a gift to an offshore charity in her will.

One of the specific reasons to consider offshore charities is because countries which provide the most generous tax benefits for donating usually have the most restrictive rules on investing assets and operating a charity. Consequently, one should consider whether it is better to avoid being seduced by the initial tax benefits of the deduction for the gift to an onshore charity and look to an offshore jurisdiction that offers greater freedom to invest assets and accumulate capital in a charity. For example, the United States has generous tax incentives to donate but then taxes the unrelated business income of charities, restricts the percentage of a company that a private foundation can hold indefinitely and has stringent payout requirements to charitable causes as well as an excise tax. Canada is another country that provides

very generous tax incentives to give to an onshore charity; but then applies very conservative restrictions on how the charity can invest the capital and even more restrictive rules on how it can expend its charitable resources. The primary reason to consider an offshore jurisdiction for charity is that, from a long term perspective, it will enable the charity to grow larger, invest more flexibly and carry on more innovative charitable programs. However, it is important to select an offshore jurisdiction which will allow the charity to operate with maximum flexibility but does not have so lax judicial oversight that there is no recourse should subsequent trustees seek to divert the capital of the charity away from any public good.

BUILDING AND ACCUMULATING CAPITAL

One of the drawbacks to investing in onshore charities is that there are often significant disbursement requirements which make it difficult to accumulate capital. In the United States, a private foundation must pay out an amount equal to 5% of its investment capital annually. It must also pay an excise tax of 2% which is reduced to 1% if the 5% disbursement requirement is fully paid out in the year. In Canada a foundation has a disbursement quota equal to 3.5% of its investment assets but no excise tax. If wealth planning is designed to increase the value of the asset, then this payout requirement is a very real problem. If the income return on investments is 10% and the tax rate is 50%, the payout to charity is as large as the payout to the tax authority. If the income return is reduced to 8%, then the payout to charity is higher than the payout to the tax authority. If this capital was in an offshore charity, there would be no payout requirement and no tax. In both these situations the charity must pay out based upon unrealized capital appreciation whereas the taxpayer only pays out on taxable income actually received. Consequently, the economic argument in favour of a wealth accumulator funding a private foundation is primarily based upon the present value of the tax benefit for the initial gift. There are some large offshore charities funded with after-tax onshore money which grew into multi-billion dollar foundations primarily because of the accumulating power of not having to meet the annual disbursement quota payout to charities. Offshore charities were chosen because the appreciated and accumulated value of the investment assets ultimately available for charitable purposes was that much greater.

CONTROL OF COMPANIES

Jurisdictions such as the United States and Canada have laws which prevent a private foundation from owning more than 20% of any corporation. These excess corporate holdings laws often include shares owned personally by directors of the foundation and even persons related to them, not just shares owned directly by the foundation. Many funders of foundations built their wealth through wholly owned private corporations and it is these corporations which they want to transfer in whole or in part to their charitable foundation as part of their wealth planning. Because of

the excess business holding rules, an offshore charity is a much better vehicle for this type of asset. The challenge is to transfer the asset to an offshore jurisdiction without incurring prohibitive exit taxes or capital gains taxes.

The strategy which is often the most useful in this scenario is to use a domestic foundation to provide tax protection for the exit taxes of someone wanting to move offshore or the capital gains taxes of someone remaining. It is possible to calculate the optimum tax efficiency of what percentage of an entrepreneur's wealth should be given to a domestic foundation to reduce the tax payable and enable the entrepreneur to take the remainder of his or her wealth offshore. For example, if an investor in Canada has \$40 million in public securities and \$60 million in shares of a private business corporation, assuming the worst case tax scenario of a nil cost base on all shares, she would pay \$22 million in tax if she sold all the shares. This would leave her with \$78 million tax paid in Canada which she could take offshore with no further tax liability.

A sophisticated charitable planner would recommend that if she donated \$27 million of her public shares to her own private foundation in Canada and sold the remaining shares, her tax would be reduced to \$4 million and leave her with \$69 million to take offshore. She would have placed \$27 million in a Canadian private foundation controlled by her, whether or not she went offshore, and this money would be available for philanthropy back in the community and country in which she made her fortune.

Further, she could have sold the private corporation to an offshore charitable trust for a \$60 million promissory note. In this situation the corporation would be in a tax free offshore entity which would likely be exempt from offshore trust reporting requirements because no equity would be owned by the holder of the promissory note. All future equity would grow tax free and dividends paid could be utilized to pay off the principal of the promissory notes. These funds would come back into Canada as a tax paid return of capital, apart from any interest paid on the promissory note. The investor would effectively have achieved an estate freeze in favour of charity which would be fully tax paid by virtue of the gift to charity and the \$4 million sent to Canada Revenue Agency. The charity would not have to operate under the restrictive payout or investment rules of a private foundation in Canada. The investor could then make a lifestyle driven, rather than a tax driven, decision as to whether or not she personally wanted to go non-resident.

RELATED BUSINESS RESTRICTIONS

If a charity in the United States carries on a business which is not directly related to the charity's purposes, it will almost certainly attract an unrelated business income tax at corporate tax rates. A public foundation in Canada can carry on a related



business exempt from tax but will have its charitable registration revoked if it carries on an unrelated business. A private foundation will have its registration revoked if it carries on any business.

There are seldom similar problems in offshore charities. Because these offshore charities operate in such low tax jurisdictions, there is no incentive for the regulators to put up tax barriers to charities carrying on business. Many charitable endeavours such as consulting on environmental issues, marketing educational materials and producing religious literature, can be carried on in a more economically sustainable manner if they are operated on a business rather than a charity model. The offshore environment enables charities to develop business plans which are funded by revenue producing activities in charitable endeavours so they are sustained year after year without requiring new donations each year.

Given the low tax environment, it will usually be better for offshore charities to own and operate such businesses in for-profit corporations. This is possible because of the combination of low taxes, no excess corporate holdings restrictions and no disbursement quota payout requirements. This business *modus operandi* also attracts wealthholders who are philosophically opposed to "charity" because they believe charity creates dependence and reduces the self-worth and initiative of recipients reduced to living on the dole. Offshore charities whose trustees are committed to the philosophy that the only true charity is to give a person gainful employment can implement this philosophy without harassment by the regulator.

INNOVATION IN CHARITABLE APPLICATIONS

The advantages of dealing with an offshore charity are not limited to investment issues such as excess corporate holdings and the payment of disbursement quotas. Onshore charities deal with a very restrictive definition of charity which limits their ability to fund public benefit causes which are innovative and evolving. In Canada, sports are still not considered to be charitable. While the new English *Charities Act, 2006* has expanded the list of causes that are considered charitable in this country, it introduces into statute a test of public benefit which was presumed to be met under the common law. This may make it much more difficult for onshore charities to make donations to the public schools which are important to many wealthholders in England.

The greater problem is that the law of charity lags behind social innovation. It was centuries before the law of charity evolved from recognizing eleemosynary charity to including the advancement of education, the advancement of religion and other purposes beneficial to the community. Prevention of cruelty to animals was not recognized as being charitable because teaching people not to be cruel to animals might reduce their cruelty to humans. However, the courts have said that preventing



cruelty to human beings by way of torture is not a charitable purpose because it might be a political purpose.¹ The law of charity was slow to recognize preserving the environment was charitable because it was not recognized to directly benefit humans. However, now that most environmental purposes are recognized as being charitable, the law of charity impedes the most effective response, being the promotion of laws and regulations that enforce environmental standards, on the basis that it involves advocacy and political mobilization.

It is reasonably simple to find offshore jurisdictions which do not apply the common law definition of charity and have a much broader definition of public good. Even those jurisdictions which adhere to the common law are less likely to interpret it restrictively because they do not have the fiscal concern which is the greatest reason for the courts to restrict the interpretation of charity.²

ACCESS TO EQUITY AND DEBT FINANCING

There is another set of reasons that wealth planners should consider using offshore charities when advising on the multi-generational transfer of wealth. Most wealth planners considering charity focus on the tax issues. In reality, matrimonial property settlements and spendthrift heirs are a far greater threat to maintaining control over wealth for many generations than taxes. The power of wealth comes from the ability to control the investment of capital. If assets are in an offshore charity they are not part of the divorce settlement when a family member seeks his second trophy wife. If the trustees are acting responsibly the capital cannot go to fund the cocaine habit and extravagant lifestyle of an "heir" who is not contributing in a responsible way to the endeavours of the foundation.

However, a foundation can be structured so that it is controlled by the family for generations to come. It can pay very significant fees for executive services provided on a merit basis by family members. The foundation can invest in industries and endeavours which complement and benefit the businesses in which the family retains proprietary equity. The foundation can also provide debt financing to the family's proprietary businesses. The foundation can also legitimately fund the charitable, artistic and public benefit endeavours of family members who are not equipped to manage business enterprises or have no interest in the historic family business.

This type of planning would not involve the entire estate but could apply to that portion of the assets which goes to permanence of wealth and the power associated with capital rather than the portion used to fund lifestyles. It also could come from recognizing that the perception of wealth and power significantly flows from having

¹ *Action by Christians for the Abolition of Torture v. Canada* [2002] FCA 499

² *A.Y.S.A. Amateur Youth Soccer Association v. Canada (Revenue Agency)* 2007 SCC 42 at para. 28.

funds available for community purposes. The private wealth of the family is not reduced to the extent that future disbursements out of the family's foundation fund this "perception" of wealth and the power in the community which flows from it. Much of the money actually going into the foundation can indirectly come from the tax savings involved in charity estate planning.

It is likely better that this planning moves assets to a foundation in an offshore jurisdiction which has a civil law understanding of public benefit and a more liberal understanding of conflict of interest than the English courts. The objective for both the family and public good is to find a jurisdiction which will allow a liberal and benevolent policy of utilizing foundation assets in ways which indirectly benefit the funder's family but protects those assets from being privatized, squandered or expropriated by the funder's heirs in the future. The public benefits by attracting large amounts of capital into a structure which requires that the income earned and capital accumulated be used for public benefit. This capital is more likely to be attracted into a foundation if the funder knows that his family can benefit from being paid generous executive compensation for managing the foundations assets and that the assets investment may indirectly benefit their other businesses. The funder is also likely to consider this if it is clear that the foundation can provide grants to descendants for legitimate services in the charitable or public benefit sector. These descendants will not live with the wealth and luxury of the funder but will be protected from penury and have the dignity of funding to pursue their artistic or religious passions or to be employed in fields of education, health, public service and many other endeavours which benefit the public.

CONCLUSION

Offshore charities are useful components of sophisticated wealth planning. Utilizing them effectively requires understanding the benefits and values of assets devoted to public good in terms which go beyond the immediate tax benefits of a charitable donation deduction. They should only be used when altruism is a significant component of the funder's motivation and a jurisdiction should be chosen which enables the courts to intervene to prevent blatant abuse should the heirs of the funder misunderstand the philanthropic intent which is integral to sophisticated planning allowing the benefits set out in this paper.