New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

NYSBA

March 11, 1998

Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3120
Washington, D.C. 20220

Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report prepared by the Committee of Estates and Trusts of the Tax Section of the New York State Bar Association commenting on the proposed regulations under Section 7701(a)(30)(E) and (31) of the Internal Revenue Code ("Code"), relating to the determination of whether a trust is "foreign" for purposes of the Code. The proposed regulations implement changes in the Code enacted as part of the Small Business Protection Act of 1996.

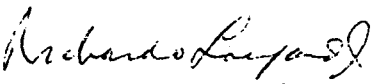
The report urges that consideration be given to amending the Code to extend to all trusts an election similar to that given by Section 1161 of the Taxpayer Relief Act of 1997 to trusts in existence on August 20, 1996.

Until such time as such legislative relief is enacted, the report urges that the proposed regulations be modified to reduce their apparent bias in favor of treating trusts as foreign. Thus, the report urges that the tests set forth in the proposed regulations for determining when a trust is foreign be modified to reduce the risk that U.S. persons wishing to organize a domestic trust may inadvertently fail to meet such tests and find that they have inadvertently organized a foreign trust. The report recognizes that, as currently drafted, the regulations gives desirable assurance to foreigners that trusts which they wish to treat as foreign trusts will be so treated but suggests that certainty can be given to foreigners without the use of tests which may prove to be a trap for unwary U.S. persons wishing to create domestic trusts. The report comments on specific portions of the proposed regulations, noting the provisions which are particularly likely to give rise to these difficulties, and suggests changes to ameliorate the problems.

Finally, the report approves the regulatory confirmation that foreign trusts will not be treated as present in the United States for purposes of Section 871(a)(2) of the Code, while noting that this result is now embodied in Code Section 641(b) as well.

If we can be of any further assistance to you or your staff in finalizing these regulations, please contact either Carlyn McCaffrey, the principal drafter of this report, at (212) 310-8136, or the undersigned.

Sincerely,



Richard O. Loengard, Jr.
Chair

CC: Stuart L. Brown
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Jonathan Talisman
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Joseph H. Guttentag
Deputy Assistant Secretary - Int'l Tax Affairs
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 1334
Washington, D.C. 20220

Philip R. West
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 4206
Washington, D.C. 20220

James A. Quinn
Internal Revenue Service
(CC:DOM:CORP:R (Reg. - 251703-96)
P.O. Box 7064
Room 5226
Ben Franklin Station
Washington, D.C. 20044

NEW YORK STATE BAR ASSOCIATION TAX SECTION COMMENTS ON PROPOSED REGULATION § 301.7701-7 -- TRUSTS --DOMESTIC AND FOREIGN[1]

This report comments on proposed regulation § 301.7701-7, relating to new Code § 7701(30)(E) and (31), which provides a new rule for determining whether a trust is a United States person or a foreign person. The proposed regulation, which was issued on June 5, 1997, also sets forth the United States income tax consequences of foreign trust status.

New Code § 7701(a)(30)(E) and (31) was enacted as part of the Small Business Job Protection Act of 1996 (the "Act"). Under prior law there was no clear standard for determining a trust's nationality. The former statutory definition consisted only of a statement that a foreign trust is a trust

> "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under Subtitle A."

This statement is merely descriptive of the consequences of foreign trust status and did not give any guidance as to the determination of whether that status existed. Judicial and administrative authority partially filled the definitional gap by establishing a test that required the weighing of a trust's foreign contacts against its United States contacts.[2]

Because other provisions of the Act impose major requirements and potential penalties on trusts that are classified as foreign, Congress believed it appropriate to provide a more objective test for determining whether a trust is a United States person (a "domestic trust") or a foreign trust.[3]

In addition, the Treasury Department, which originally proposed the definitional change, wanted to

> "increase the flexibility of settlors and trusts administrators to decide where to locate and in what assets to invest. For example, if the location of the

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[1]. This report was prepared by the Committee on Estates and Trusts of the Tax Section of the New York State Bar Association. Its principal drafter was Carlyn. S. McCaffrey. Helpful comments were received from Sherwin Kamin, Richard O. Loengard, Jr. and David Miller.

[2]. *See, e.g. B. W. Jones Trust v. Commissioner*, 132 F. 2d 914 (4th Cir., 1943); *First National City Bank v. Internal Revenue Service*, 271 F. 2d 616 (2d Cir., 1959), *cert. denied*, 361 U.S. 948 (1960); Rev. Rul. 60-181, 1960-1 C.B. 257.

[3]. *See* House of Representatives Report No. 542, 104th Cong., 2d Sess. 25 (May 3, 1996) ("House Report") and Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress 270 (December 18, 1996)("Blue Book").

administration of the trust were no longer a relevant criterion, settlors of foreign trusts would be able to choose whether to administer the trusts in the United States or abroad based on non-tax considerations.[4]

We understand that one of the principal objectives Treasury sought to achieve by implementing this new definition was to level the competitive playing field for trust business between United States and foreign institutions. Under the former definition, a foreign person who might have preferred to use a United States financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a United States domestic trust. Under the new law a foreign person can easily use a United States financial institution without creating a domestic trust.[5]

New Code § 7701(a)(30)(E) and (31) established the following two requirements a trust must satisfy if it is to be characterized as domestic:

1. A court or courts within the United States must be able to exercise primary supervision over administration of the trust; and

2. One or more United States fiduciaries must have the authority to control all substantial decisions of the trust.[6]

Any trust that does not satisfy both requirements is a foreign trust.

Although the new Code provision establishes a more objective method for determining whether a trust is domestic or foreign, it falls short of establishing the bright line test that should be established in view of the harsh penalties that may be imposed as a result of the foreign status of a trust. Moreover, the new definition did nothing to disengage the operation of Code § 871(a)(2). Under this provision, a foreign trust which had a United States financial institution as its trustee might have been treated as present in the United States by reason of the residence of its trustee. Such treatment would expose the foreign trust to United States income taxation on gain from the sale of investment assets. This result would be inconsistent with a Congressional intent to encourage foreign persons to use United States financial institutions as trustees.[7]

The proposed regulations significantly decrease the ambiguities in the statutory

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[4]. Treasury Department, "General Explanation of the Administration's Revenue Proposals" 25 (February 7, 1995)("Treasury Explanations").

[5]. This understanding is based on conversations between David K. Sutherland, former Associate International Tax Counsel and a principal draftsperson of the new statutory definition, and certain of the individuals who participated in the preparation of this report.

[6]. Section 1601(i)(3)(A) of the Taxpayer Relief Act of 1997 changed the word "fiduciaries" to "persons."

[7]. The possibility of this result was abrogated by § 1601(i)(3)(B) of the Taxpayer Relief Act of 1997, which provides that, for purposes of determining the taxable income of a foreign trust (or foreign estate) the foreign trust shall be treated as if it were an individual who is not present in the United States at any time.

definition and resolve the problem under Code § 871(a)(2).

Proposed Regulation § 301.7701-7

I. In General

A. The Definition

1. The Safe Harbor

The proposed regulation creates a "safe harbor" that will ensure domestic trust status even if technical compliance with Code § 7701(a)(30)(E) has not been achieved. The safe harbor, which is described in paragraph (c) of the proposed regulation, provides that a trust is a domestic trust if the following three requirements are met:

a. The trust has only United States fiduciaries as defined in paragraph (e) of the proposed regulation.

b. The trust is administered exclusively within the United States pursuant to the terms of a trust instrument.

c. The trust is not subject to an automatic migration provision described in paragraph (d)(2)(v) or (e)(3) of the proposed regulation.

Trusts that are not secure within the safe harbor must satisfy both the "court test" and the "control test" to be domestic trusts.

2. The Court Test

The "court test," which is described in paragraph (d) of the proposed regulation, is the regulatory explanation of the statutory requirement that "a court or courts within the United States must be able to exercise primary supervision over administration of the trust." The explanation provides the following critical definitions:

a. "Court" includes federal as well as state and local courts.

b. "United States" means the fifty states and the District of Columbia.

c. "Is able to exercise" means "that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust."

d. "Primary supervision" means the judicial "authority to determine substantially all issues regarding the administration of the entire trust . . . even if another court has jurisdiction over a trustee, a beneficiary, or trust property."

e. "Administration" means "the carrying out of the duties imposed on a

fiduciary by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, defending the trust from suits by creditors, and determining the amount and timing of distributions."

Paragraph (d) of the proposed regulation describes four types of trusts that satisfy the court test and one that does not. The four types that satisfy the court test are:

a. Trusts that are registered in a court within the United States by an authorized fiduciary under a state statute substantially similar to the Uniform Probate Code, Article VII, Trust Administration.[8]

b. Testamentary trusts if all fiduciaries of the trust have been qualified as trustees by a court within the United States.

c. Inter vivos trusts if the fiduciaries and/or beneficiaries take steps with a court in the United States to cause the administration of the trust to be subject to the primary supervision of such court.

d. Trusts that are subject to primary supervision with respect to their administration by a United States court and a foreign court.

The type of trust that does not satisfy the court test is a trust whose trust instrument contains a provision that would cause the trust to migrate from the United States if a United States court attempted to assert jurisdiction over it or attempted to supervise its administration.

1. The Control Test

The "control test," which is described in paragraph (e) of the proposed regulation is the regulatory explanation of the statutory requirement that one or more United States fiduciaries must have the authority to control all substantial decisions of the trust. The explanation provides the following critical definitions:

a. "Fiduciary" includes any person described in Code § 7701(a)(6) and Treas. Reg. § 301.7701-6(b). Code § 7701(a)(6) and its corresponding regulation define "fiduciary" as "a . . . trustee, . . . or any person acting in any fiduciary capacity for any person." In addition, the term includes any person, whether or not she is a fiduciary within the meaning of Code § 7701(a)(6), who has the power to control one or more substantial

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[8]. § 7-201 of the Uniform Probate Code gives exclusive jurisdiction over the internal affairs of a trust to the courts of the state in which a trust is registered. Sixteen states have adopted the Uniform Probate Code. They are Alaska, Arizona, Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota, and Utah. 8 Uniform Laws Annotated 1 (West Supp. 1996).

decisions of the trust, as defined below.[9]

b. "United States fiduciary"means a fiduciary that is a United States person within the meaning of Code § 7701(a)(30), including, for example, individuals who are United States citizens or residents, domestic corporations, and domestic partnerships.

c. "Substantial decisions" means, with an important exception described below, all decisions other than ministerial decisions, that any person is authorized to make under the terms of the trust instrument or applicable law. Such decisions include, but are not limited to:

(1) The timing and amount of distributions;

(2) The selection of beneficiaries;

(3) The power to make investment decisions;

(4) The power to determine whether receipts are allocable to income or principal;

(5) The power to terminate the trust;

(6) The power to compromise, arbitrate, or abandon claims of the trust and to decide whether to sue on behalf of or defend suits against the trust; and

(7) The power to remove, add or replace a trustee.

Ministerial decisions "include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions made by the fiduciaries."

A decision is not a substantial decision if it can be made by a grantor or, in the case of a decision that affects the portion of a trust in which a beneficiary has an interest, by that beneficiary, unless the grantor or the beneficiary, as the case may be, is acting as a fiduciary under Code § 7701(a)(6) (a "§ 7701(a)(6) fiduciary"). This means, for example, that the power to revoke a trust exercisable by an individual holding a power of appointment who is neither a beneficiary nor the grantor is the power to make a substantial decision, but that such a power held by the grantor is not.

d. "Control" means the power to make all of the substantial decisions of the

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[9]. This definition of the term "fiduciaries" is no longer needed in view of § 1601(i)(3)(A) of the Taxpayer Relief Act of 1987, which changed the word "fiduciaries" to "persons."

trust, with no other person having the power to veto such decisions, other than the grantor or a beneficiary acting with respect to her interest in the trust (unless the grantor or beneficiary is acting as a Code § 7701(a)(6) fiduciary).

If an inadvertent change in fiduciaries would cause a trust to change residence, the proposed regulation permits the trust to retain its pre-change status if the fiduciaries are adjusted within six months of the inadvertent change.[10] Inadvertent changes include the death of a fiduciary or her abrupt resignation.

A. The Code § 871(a)(2) Issue

Code § 871(a)(2) provides that a nonresident alien individual who is present in the United States for a period of 183 days or more in a taxable year is subject to a 30 percent tax on her net gains allocable to sources within the United States. Under Code § 865(a)(1) the sale of personal property is generally sourced according to the residence of the seller. But, under Code § 865(e)(2)(A), a nonresident alien who maintains an office in the United States, has United States source income to the extent she sells personal property attributable to that office. Prior to the Taxpayer Relief Act of 1997, it was unclear under the Code whether a trust that is a foreign trust within the meaning of new Code § 7701(a)(31) but that has a United States trustee with an office in the United States would be treated as having United States source income to the extent that trustee directed the sale of personal property.

Paragraph (a)(3) of the proposed regulation clarifies this issue by providing that a foreign trust will not be considered to be present in the United States for purposes of Code § 871(a)(2).

The same result is now achieved by statute. Section 641(b) was amended by the Taxpayer Relief Act of 1997 to provide that in determining the income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the United States at any time.

I. General Comments

New Code § 7701(a)(30)(E) and (31) and the proposed regulation make it simple for United States and foreign persons to create foreign trusts. They do not, however, make it simple to create a domestic trust. In fact, they both seem curiously biased in favor of foreignness.

For example, a United States person who wants to name her brother who is a nonresident alien as the trustee, or as one of two trustees, of her testamentary trust for her children will be able to do so only if she is willing to have her trust treated as foreign.

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[10]. Such a change can now result in immediate income tax liability under § 684 as enacted by § 1131 of the Taxpayer Relief Act of 1997. Under prior law, such a change could have resulted in immediate tax liability under § 1491 of the Code, which was repealed by § 1131 of the Taxpayer Relief Act of 1997.

We do not see what policy goal is advanced by forcing United States persons to create foreign trusts. Indeed, it is likely that less United States income taxes will be collected if more trusts are foreign than would be collected if more were domestic.

We think it would be sensible if Code § 7701(a)(30)(E) were amended to permit a settlor or her trustees to elect domestic status so that those who would like to avoid foreign status and to pay United States income taxes currently will be able to do so. Section 1161 of the Taxpayer Relief Act of 1997 gave Treasury the power to create, by regulations, such an election for trusts which were in existence on August 20, 1996 (other than so-called grantor trusts) and which were treated as United States persons on the day before the enactment of the Act.

We see no reason why such an election should not apply to all trusts, regardless of when created. The United States should encourage, rather than discourage, the creation of domestic trusts.

Unless and until such a choice is legislatively provided, we believe the proposed regulation should reduce its bias in favor of foreignness by, for example, narrowing the kinds of decisions that are treated as "substantial decisions," the control of which by foreign fiduciaries causes a trust to be foreign and by changing the control test so that the authority to determine less than substantially all of the issues regarding the administration of the trust is sufficient. While we recognize the benefits, in the form of certainty, which an objective test brings, we believe that the changes we propose could be adopted without substantially interfering with the ability of those who wish to form a trust that is foreign to do so. At the same time we think changes are needed to ensure that United States persons who wish to create domestic trusts are not found to have inadvertently organized a foreign trust.

Treasury's focus ought to be on those matters relating to the administration of a trust that are likely to affect its enhanced enforcement program relating to foreign trusts. It is difficult to see how this program would be adversely affected if a trust, whose only foreign connection is the foreign status of an individual who has the right to veto the appointment of new trustees, were permitted to treat itself as domestic. To the extent it believes the program would be adversely affected, it could protect against whatever risk it perceives by requiring the same level of disclosure from such trusts as it does from trusts that are treated as foreign trusts.

II. Specific Comments

A. The Definition

1. The Safe Harbor

We fear that the safe harbor is seriously flawed because it is so restrictive that it is likely to benefit only a few, *i.e.*, those who are best advised. The regulation does not make clear whether or not it is mandatory that the trust document itself specify a United States trustee; while Regulation § 301.7701-7(c) does not explicitly state such a

requirement, the preamble and the example in paragraph (c) seem to point the other way. Since the normal United States trust document does not mandate a United States trustee even if that is clearly contemplated, we urge that the safe harbor be made clearly applicable in the case of any trust if a majority of the trustees are United States persons.

Similarly, in that example, there is a sentence reading "No person other than DC has any power over the trust." We do not know what "power" means in this context, *i.e.*, whether it means that under the safe harbor all substantial decisions with respect to the trust must be made by the trustee in the United States, thus perhaps precluding the use of a foreign investment advisor. If so, this would limit the usefulness of the safe harbor. We urge that a trust should be able to satisfy the test if it is in fact administered in the United States, again, regardless of whether this is mandated by the trust document. In any event, the relevant rules should be made explicit and spelled out in detail.

Another prong of the safe harbor test requires that the trust not have an automatic migration provision as defined in paragraph (d)(2)(v) or (e)(3) of the proposed regulation. An automatic migration provision is a provision that provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust would cause the trust to migrate. Example 3 of paragraph (d)(3) illustrates the application of this provision by describing a migration clause that is triggered by a suit in a United States court by a creditor of the trust.

While a migration clause of this type might appropriately cause the trust to be foreign, the text seems far broader. It would seem to apply, for example, to the more typical provision that would cause a trust to migrate in the event that the United States were invaded by a foreign power or in the event that the United States enacted a law that would confiscate the assets of trusts created by certain persons. No good purpose is served by forcing all trusts with these types of clauses to be treated as foreign.

We believe the migration clause provision should not extend to migrations triggered by events that are not particular to a given trust or its beneficiaries, trustees or grantor.

2. The Court Test

We believe the "court test" may work in ways which will trap unwary United States taxpayers. It appears to us that under section (d)(2) of the regulations, it may be mandatory, in order to satisfy this test, that even in the case of the simplest inter vivos trust, *e.g.*, one established by a United States citizen and resident for her United States children, that that trust be "registered by an authorized fiduciary in a court within the United States" (and that will suffice only if the relevant state statute meets certain standards), or that the "fiduciaries and/or beneficiaries take steps with a court . . . that cause the administration of the trust to be subject to the primary supervision of such court." While the definitions of the court test (section (d)(1) of the regulations) do not appear to require this, these requirements are found in "[S]ituations that meet the court test" in section (d)(2) of the regulations. If those situations are intended to be exclusive, then again many, if not most, United States trusts will fail the test. Further, the proposed regulations suggest that the court test may not be met, without some affirmative action, by

trusts that are unquestionably subject to the jurisdiction of a United States court under applicable statutes and/or the provisions of the trust instrument. Hence, clarification or a substantive change is vitally necessary to make it clear that no action is necessary to satisfy the court test if a United States court in fact would have jurisdiction under applicable law.

The court test is also subject to the migration clause provision described above. If a trust that otherwise satisfies the court test has such a provision it will be a foreign trust. For the reasons described above, we do not believe the migration clause should prevent a trust from being treated as domestic to the extent it does so in its present form.

3. The Control Test

a. Breadth of Test

The control test is overly broad, both in terms of the kinds of powers that are treated as substantial and in terms of the way in which "control" is defined. It is likely to force trusts to be foreign simply because one or more foreign persons has even a relatively minor role to play in the trusts' administration.

For example, the power to make trust investment decisions if held by a foreign person, even if the decisions may be vetoed by a United States person, will cause the trust to be foreign. This means that a trust will be a foreign trust if a United States trustee revocably delegates investment authority to a foreign investment advisor.

In addition, the power to remove, add or replace a trustee, if held by a foreign person (other than the grantor or beneficiary) will cause the trust to be foreign. Granting such significance to this kind of power is inconsistent with the regulations under Subchapter J, Subpart E,[11] and with the Internal Revenue's position with respect to the transfer tax consequences of a retained power to change trustees.[12]

Control is defined as the ability to make a decision without being subject to veto by anyone else. The statute could have been interpreted to treat a United States person as being in control of a particular decision if she had the power to veto another person's ability to make the initial decision.

As suggested above, the characterization of decisions as substantial and the manner in which control is defined should be narrowed in order to make it easier for those who wish to have trusts treated as domestic and to pay United States tax currently to accomplish this objective. No good tax policy is served by putting statutory and regulatory obstacles in their path.

b. Powers Held by Grantors and Beneficiaries

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[11]. *See* Treas. Reg. 1.674(d)-2.

[12]. *See* Rev. Rul. 95-58, 1952-2 C.B. 191.

The proposed regulations' treatment of powers exercisable by grantors and beneficiaries has no statutory basis and is likely to defeat the competitive level playing field that Treasury was trying to achieve when it proposed the statutory basis in favor of foreignness. Nothing in the statute suggests that the significance of a power is diminished by the fact that it is held by a grantor or beneficiary. The kind of trust a nonresident alien is likely to be willing to create within the United States with a United States fiduciary is not one of which she will be trustee. Thus, the controls she retains over the trust, although extensive, will be exercisable by her in an individual rather than a fiduciary capacity. The proposed regulation treats all such powers as nonsignificant and her trust, therefore, will be domestic rather than foreign.

4. Summary

While we recognize the desirability for certainty in determining the United States status of trusts, we believe these proposed regulations go much too far in favoring foreign status, and by reason of the restrictions they place on the creation of domestic trusts, will cause confusion and hardship to many United States taxpayers, who organize trusts in the United States without thought to probable foreign status. It serves no purpose to turn § 7701(a)(30)(E) into a confusing trap for average United States taxpayers, largely in order to create certainty for foreigners.