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December 9, 2008

The Honorable Max Baucus
Chairman
Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles Grassley
Ranking Minority Leader
Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles B. Rangel
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Jim McCrery
Ranking Minority Leader
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Classification of Trusts as Domestic or Foreign

Dear Chairman Baucus, Chairman Rangel, Senator Grassley, Representative McCrery:

I write to you in my capacity as president of the American College of Trust and Estate Counsel ("ACTEC"). The American College of Trust and Estate Counsel is a professional association of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities. The College offers technical comments about the law and its effective administration. It does not take positions on matters of tax policy. The comments below have been approved by the Board of Regents of ACTEC.

The comments below concern the rules governing the classification of trusts as domestic or foreign under Section 7701(a)(30)(E) and (31)(B) of the Internal Revenue Code of 1986, as amended (the "Code") and Treasury Regulations §301.7701-7.

The individuals who were principally responsible for the preparation of this report are John L. Campbell, chair of the subcommittee, and Ellen Harrison, and Virginia Coleman. The individuals who prepared and reviewed this report have substantial experience advising clients on the Federal tax issues relevant to moving into and out of the United States.

Although the individuals who prepared these comments have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such individual (or the firm or organization to which such individual belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these comments.

We welcome the opportunity to meet with you to discuss our recommendations in more detail and answer any questions you may have.

The current statutory definitions of domestic trust and foreign trust were introduced in 1996 by the Small Business Jobs Protection Act (the "Act").[1] Prior to the enactment of these definitions, there was no clear standard for determining the "nationality" of a trust (that is, whether a trust was domestic or foreign for federal t ax purposes). 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."[2] This statement is merely descriptive of the consequences of foreign trust status and does not provide guidance as to how to determine whether a trust is foreign.[3] Judicial and administrative authority partially filled the definitional void by establishing a test that required weighing of the trust's foreign contacts against its U.S. contacts.[4]

Code §7701(a)(30)(E) and (31)(B) attempt to provide clarity, but do so in a way that creates a strong statutory bias in favor of foreign status, as explained below. This definitional bias in favor of foreign status has important consequences – (i) it allows a trust to avoid being taxed as a domestic trust on worldwide income even where the trust has substantial U.S. connections; (2) it allows U.S. trustees to administer trusts for foreign persons without exposing the trust's worldwide income to tax as a domestic trust; and (3) it has important and often unintended adverse tax consequences for U.S. persons who are the grantors and/or beneficiaries of trusts that are classified as foreign under the Act despite having significant connections to the United States.

Under Code §7701(a)(30)(E) and (31)(B), a trust is a foreign trust unless both of the following conditions are satisfied: (i) a court or courts in the U.S. must be able to exercise primary supervision over the administration of the trust (the "court test"); and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust (the "control test").

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[1] P.L. 104-188, 110 Stat. 1755 (1996).

[2] Code §7701(a)(31) before amendment by the Act.

[3] The domestic or foreign status of an estate continues to be governed by the same provision. Code §7701(a)(31)(A).

[4] *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; Rev. Rul. 60-181, 1960-1 C.B. 257.

The court test is met under a "safe harbor" rule if the trust instrument does not direct that the trust be administered outside of the United States, the trust in fact is administered in the United States and the trust is not subject to an automatic migration provision that moves trust administration outside the United States upon the commencement of judicial proceedings against the trust.[5]

The control test is met only if U.S. persons control all of the following so-called "substantial decisions": (i) whether and when to make distributions to beneficiaries; (ii) the amount of distributions; (iii) the selection of a beneficiary; (iv) whether a receipt is allocable to income or principal; (v) whether to terminate a trust; (vi) whether to compromise, arbitrate or abandon claims of the trust; (vii) whether to sue on behalf of the trust or defend suits; (viii) whether to remove, add or replace a trustee: (ix) whether to appoint a successor trustee to replace a trustee who has died, resigned or otherwise ceased to act as trustee even if not accompanied by a removal power unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic or vice versa; and (x) investment decisions, except that if a U.S. person appoints a foreign investment advisor and retains the power to terminate the investment advisor's power to make investment decisions at will, the hiring of a foreign investment advisor will not cause the trust to be classified as a foreign trust.

The control test makes it very difficult for some foreign persons to create a domestic trust. For example, a foreign beneficiary cannot have a limited power of appointment, or a power to select fiduciaries. Frequently, the only individuals whom a foreign grantor knows well enough to select as a fiduciary also are foreign persons, but the grantor may wish to create a domestic trust because the beneficiaries are U.S. persons. There does not appear to be a good reason to make the creation of a domestic trust so difficult.

Treasury regulations do make some exceptions to the control test. For example, the control test will not apply to certain employee benefit trusts or to "investment trusts" defined in Treasury Regulation §301.7701-4(c) provided that all trustees are U.S. persons and at least one of them is a bank as defined in Code § 581, all sponsors are U.S. persons and beneficial interests are widely offered for sale primarily in the U.S. to U.S. persons.[6] In addition, a grace period of 12 months is allowed to correct for an inadvertent failure of the control test due to a change in any person that has the power to make substantial decisions.[7] Treasury Regulations allow the Commissioner to designate other categories of trusts for exceptions to the control test.[8] Transition rules allow trusts created between August 19, 1996 (the date of enactment of the Act) and April 5, 1999 that satisfied the control test under proposed regulations to be amended to satisfy the control test under final regulations prior to December 31, 1999, and pre-enactment trusts that had been filing as domestic trusts to elect to continue to be classified as domestic

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[5] Treasury Regulation §301.7701-7(c)(1).

[6] Treas. Reg. §301.7701-7(d)(1)(iv).

[7] Treas. Reg. §301.7701-7(d)(2). For example, if a US trustee of domestic dies or resigns and the successor is a foreign person, the trust may maintain its classification as a domestic trust if the foreign trustee is replaced by a U.S. trustee within 12 months.

[8] Treas. Reg. §301.7701-7(d)(i)(iv)(J).

trusts.[9] The election to continue to be taxed as a domestic trust was authorized by Section 1161 of the Taxpayer Relief Act of 1997.[10]

Because the classification of a trust as a foreign trust has important tax consequences, which are described below, we recommend that, where suitable protection against a trust evading enforcement of U.S. administrative or judicial action is secured (*e.g.*, where the trust instrument contains no automatic migration provisions and where the trustees appoint a U.S. Agent for service of process), trusts that are classified as foreign be permitted to elect to be treated and taxed as domestic trusts. In addition to having the salutary effect of exposing the trust's worldwide income to U.S. tax, this election would avoid technical drafting errors from exposing U.S. settlors and beneficiaries to harsh penalties. We note that precedent exists for such an election under newly enacted Code §2801(d)(4)(B)(iii) pertaining to the new tax on gifts or bequests to U.S. persons from covered expatriates. Where a trust has erroneously been filing returns consistently as a domestic trust, we recommend that any penalties or adjustments to income resulting from such mistake be waived – in effect allowing the election to be retroactive.

Some of the important differences between the tax treatment of foreign and domestic trusts are summarized below.

1. Information reporting. A transfer to and a receipt from a foreign trust are reportable on Form 3520.[11] The penalty for failing to report is 35% of the amount involved.[12] If the foreign trust is treated as owned by a U.S. taxpayer, Form 3520A must be filed annually on or before March 15 and the penalty for failure to timely file is 5% of the value of the trust.

2. Grantor trust status. A foreign trust created by a U.S. taxpayer which has or may have a beneficiary who is a U.S. person is a "grantor trust" (meaning that the income of the trust is taxable to the grantor even if the income is not paid or payable to the grantor). [13]

3. Calculation of trust income. A foreign trust (unless it is a grantor trust owned by a U.S. grantor) is taxable on U.S. source income but not foreign source income.[14]

4. Withholding. Certain types of U.S. source income paid to a foreign trust are subject to withholding at the source.[15] (However, the definition of foreign trust

[9] Treas. Reg. §301.7701-7(d)(3).

[10] P.L. 105-34 (8/5/97).

[11] Code §6048.

[12] Code §6677.

[13] Code §679.

[14] Code §641(b) taxes a foreign trust in the same manner as a nonresident alien individual.

[15] Code §1441(a) imposes a 30% withholding tax on U.S. source income not connected with a U.S. trade for business which is fixed or determinable annual or periodic income. Partnerships are required to withhold for income allocable to a foreign partner. Code §1446(a). A purchaser of U.S. real property from a foreign person is required to withhold 10% of the purchase price under Code §1445(a).

for withholding purposes is not the same as the definition in Code §7701(a)(31)(B).)

5. Calculation of tax to U.S. beneficiaries. Distributions to U.S. beneficiaries are taxed differently depending upon whether the trust is domestic or foreign. Capital gains may be taxed to U.S. beneficiaries where the trust is foreign and makes current distributions to U.S. beneficiaries, but usually capital gains are taxed at the trust level only where the trust is domestic, regardless of the amount distributed to beneficiaries.[16] Distributions of previously accumulated income are taxed to beneficiaries of foreign trusts but usually are not taxed where the trust is domestic.[17] Capital gain accumulated in a foreign trust and later distributed to a U.S. beneficiary is taxed at ordinary income rates.

6. Subchapter S shareholder. A foreign trust is not eligible to be a Subchapter S corporation shareholder and this is true even if the foreign trust is a grantor trust deemed owned by a US. taxpayer.[18]

7. Loans to or from a foreign trust. Loans to or from a foreign trust are not respected as loans (and therefore are treated as gratuitous contributions or distributions) unless the loans are "qualified obligations" or the parties are not related.[19]

8. Intermediaries. Gifts received by U.S. persons from a donor who received distributions from a foreign trust within a four year period beginning two years before the date of the gift are treated and taxed as if the gift was received directly from the trust.[20]

9. Gain recognition. Code §684 treats a person who transfers assets to a foreign nongrantor trust as selling assets for fair market value. Gain, but not loss is recognized and taxed. Gain recognition applies also when the U.S. grantor of a foreign grantor trust dies, unless the assets were included in the U.S. grantor's estate and acquired a new income tax basis under Code §1014.[21] Finally, gain recognition applies if a U.S. trust becomes a foreign trust, unless the trust is a foreign grantor trust.

10. Attribution of stock to beneficiaries. Code §958(a)(2) attributes ownership of shares of a foreign corporation owned by a foreign (but not a domestic) trust to a U.S. beneficiary. Similarly, if a domestic trust owns shares in a passive foreign

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[16] Code §643(a). Capital gain of a foreign trust is included in the calculation of "distributable net income" and therefore is carried out as distributions are made to beneficiaries.

[17] Code §665(c).

[18] Code §1361(c)(2) provides at the end "This subparagraph shall not apply to any foreign trust."

[19] Code §679(a)(3)(A)(i); Treas. Reg. §1.679-4(d); Code §643(i).

[20] Code §643(h); Treas. Reg. §1.643(h)-1.

[21] Treas. Reg. §1.684-3(c).

investment company, the domestic trust will be deemed to be the "shareholder" rather than the U.S. beneficiaries of such trust.[22]

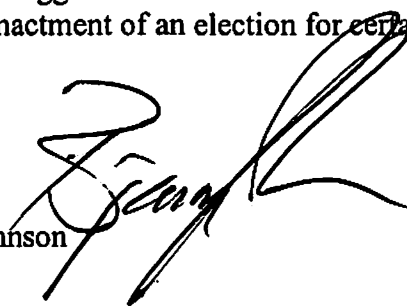
The "hair trigger" test for classification of a trust as foreign makes compliance very difficult, particularly for corporate trustees who administer a large number of trusts. Every trust must be examined and monitored to make certain that no non-U.S. person has any power that violates the control test.

We think that allowing foreign trusts to elect to be taxed as domestic trusts will be beneficial to the timely collection of tax on income accruing to or for the benefit of U.S. taxpayers and will not in any way facilitate the evasion of income taxes. The election will eliminate traps for the unsophisticated taxpayer, simplify trust administration and allow a significant number of "technically foreign" trusts that have been filing as domestic trusts to come into full compliance with the tax laws.

To avoid possible "gamesmanship" of the tax rules, we suggest that any election be revocable only with the consent of the Commissioner.

We appreciate your consideration of our suggestions and welcome the opportunity to meet with your representatives to assist in the enactment of an election for certain foreign trusts to be taxed as domestic trusts.

Sincerely,



Bjarne Johnson
President

cc: John Buckley
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Joshua Odintz
Ellen McCarthy

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[22] Treas. Reg. §1.1291-9(j)(3).

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