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.

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.

---

[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.

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

---

[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.