

Notice of Proposed Rulemaking and Notice of Public Hearing

Residence of Trusts and Estates—7701

REG-251703-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations providing guidance relating to the definition of a trust as a United States person (domestic trust) or foreign trust. The proposed regulations reflect changes to the law made by the Small Business Job Protection Act of 1996 and affect the determination of the residency of trusts for federal tax purposes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by August 4, 1997. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for September 16, 1997, at 10 a.m. must be submitted by August 26, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-251703-96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-251703-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Internal Revenue Service Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, James A. Quinn or Eliana Dolgoff, (202) 622-3060; concerning submissions and the hearing, Evangelista Lee, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1907 of the Small Business Job Protection Act of 1996 (the Act), Public Law 104-188, 110 Stat. 1755 (August 20, 1996) amended sections 7701(a)(30) and (31) to provide a new rule for determining whether a trust is domestic or foreign (the new rule does not apply to estates), effective for tax years beginning after December 31, 1996, or at the election of the trustee of a trust to tax years ending after August 20, 1996. Section 7701(a)(30)(E) provides that the term *United States person* means any trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust (court test), and (ii) one or more United States fiduciaries have the authority to control all substantial decisions of the trust (control test). Section 7701(a)(31)(B) provides that the term *foreign trust* means any trust other than a trust described in section 7701(a)(30)(E).

Prior to the Act, section 7701(a)(31) provided that *foreign estate* and *foreign trust* mean an estate or trust, as the case may be, 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. Accordingly, whether a trust was domestic or foreign depended on whether the trust was more comparable to a resident or nonresident alien individual. Thus, it was necessary to consider and weigh various factors such as the location of the assets, the country under whose laws the trust was created, the residence of the fiduciary, the nationality of the decedent or settlor, the nationality of the beneficiaries, and the location of the administration of the trust. See Rev. Rul. 60-181 (1960-1 C.B. 257), citing *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943).

The Act made a number of procedural and substantive changes to the tax treatment of foreign trusts that were designed to improve tax compliance and administration. In making these overall changes, Congress believed that it would be appropriate to have an objective test for determining whether a trust is foreign or domestic. Consequently, it enacted the two-part test set forth above.

Explanation of Provisions

The proposed regulations provide that a foreign trust is taxed in the same manner as a nonresident alien. Thus, once a trust is determined to be a foreign trust, the residency of the fiduciary of the trust is not relevant in determining the residence of the trust. Additionally, section 7701(b) does not apply to determine whether a trust is a resident of the United States, and a foreign trust is not present in the United States for purposes of section 871(a)(2).

The proposed regulations require that the terms of the trust instrument and applicable law be applied to determine whether the court test and the control test are met. The residency of a trust may change if the result of the court test or control test changes.

The Safe Harbor

The IRS and Treasury Department were concerned that the lack of authority construing trust law in many states would make it difficult for taxpayers to determine whether a trust is domestic or foreign under the court and control tests. Specifically, it may be difficult to determine whether the court of a particular state would assert primary supervision over the administration of a trust if that trust had never appeared before a court. Therefore, the proposed regulations provide a safe harbor based upon the principle that when the administration of a trust is conducted entirely within a particular locality, the local courts will exercise primary supervision over the trust. Restatement (2d) of Conflicts of Laws § 267. The safe harbor provides that a trust is a domestic trust if, pursuant to the terms of a trust instrument, the trust has only United States fiduciaries, such fiduciaries are administering the trust exclusively in the United States, and the trust is not subject to an automatic migration provision. The IRS and Treasury Department request comments on whether this special rule is sufficient to address the lack of a well-developed body of local law.

The Court Test

The proposed regulations define the relevant terms for purposes of the court test. The term court includes any federal, state, or local court.

The term *the United States* includes only the States and the District of Columbia. Accordingly, a court within a

territory or possession of the United States or within a foreign country is not a court within the United States and a trust subject to the primary supervision of such a court fails to meet the court test. The IRS and Treasury Department request comments on the conclusion that the term *the United States* is used in its geographical sense and therefore excludes territories and possessions.

The term *is able to exercise* means that if petitioned, a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.

The term *primary supervision* means that a court has or would have the authority to determine substantially all issues regarding the administration of the trust. Simply having jurisdiction over the trustee, a beneficiary, or trust property is not primary supervision.

The term *administration* of the trust means the carrying out of the duties imposed on a fiduciary by the terms of the trust instrument and applicable law.

In order to provide certainty to taxpayers, the proposed regulations provide some bright-line rules for satisfying the court test. A trust meets the court test if an authorized fiduciary registers the trust in a court within the United States under a state statute that has provisions substantially similar to Article VII, *Trust Administration*, of the Uniform Probate Code.

In the case of a testamentary trust established under a will probated within the United States, if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States, the trust meets the court test.

In the case of an inter vivos trust, if the fiduciaries or beneficiaries take steps with a court within the United States (such as the filing of a written request with the court) that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test.

The proposed regulations clarify that if both a United States court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust will be considered to meet the court test.

The proposed regulations contain rules addressing automatic migration clauses, also known as "flee clauses." The proposed regulations provide that the court test is not met if a United States court's attempt to assert jurisdiction or otherwise supervise the adminis-

tration of the trust directly or indirectly would cause the trust to migrate from the United States.

The Control Test

The control test requires that one or more United States fiduciaries have the authority to control all substantial decisions of the trust. Under the proposed regulations, the term fiduciary refers to any person described in section 7701(a)(6) and § 301.7701-6(b). For purposes of the control test, any other person that has the power to control substantial decisions of the trust, for example a trust protector, will also be treated as a fiduciary. The proposed regulations treat such persons as fiduciaries because they are exercising powers traditionally held by fiduciaries or because they can effectively exercise control over the fiduciaries.

Substantial decisions are those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Included in the proposed regulations is a nonexclusive list of substantial decisions. Substantial decisions do not include decisions exercisable by a grantor that is not a fiduciary of the trust, or decisions exercisable by a beneficiary that affect only the beneficiary's interest in the trust.

In accordance with the legislative history, the proposed regulations provide that United States fiduciaries have the authority to control all substantial decisions of the trust when they have the power by vote or otherwise to make all of the substantial decisions of the trust and no foreign fiduciary has the power to veto the substantial decisions of the United States fiduciaries.

The proposed regulations contain rules addressing automatic migration clauses, also known as "flee clauses." The proposed regulations provide that the control test is not met if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States fiduciaries.

The proposed regulations are proposed to apply to trusts for taxable years beginning after December 31, 1996, and to a trust whose trustee has elected to apply sections 7701(a)(30) and (31) to the trust for taxable years ending after August 20, 1996, under section 1907(a)(3)(B) of the Act. Notice 96-65

(1996-52 I.R.B. 28) grants trusts that meet the conditions specified in that notice additional time to comply with the new domestic trust criteria contained in the Act and allows such trusts to continue to file as domestic trusts during the period specified in that notice. Notice 96-65 also addresses the time and manner for making the election provided by the Act to apply the new domestic trust criteria retroactively for taxable years of the trust ending after August 20, 1996. Notice 96-65 remains in effect and should be consulted for these purposes.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 16, 1997, at 10 a.m. in the Internal Revenue Service Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by August 4, 1997, and submit an outline of the topics to be discussed and the time to be devoted to

each topic (preferably a signed original and eight (8) copies) by August 26, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are James A. Quinn and Eliana Dolgoff of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:
PART

301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 301.7701-5 [Amended]

Par. 2. The last sentence of section 301.7701-5 is removed.

Par. 3. Section 301.7701-7 is added to read as follows:

§ 301.7701-7 Trusts—domestic and foreign.

(a) *In general.* (1) A trust is a United States person if—

(i) A court within the United States is able to exercise primary supervision over the administration of the trust (court test); and

(ii) One or more United States fiduciaries have the authority to control all substantial decisions of the trust (control test).

(2) A trust is a United States person for purposes of the Internal Revenue Code at any time that the trust meets both the court test and the control test. For purposes of the regulations in this chapter, the term *domestic trust* means a trust that is a United States person. The

term *foreign trust* means any trust other than a domestic trust.

(3) Except as otherwise provided in part I, subchapter J, chapter 1 of the Code, the taxable income of a foreign trust is computed in the same manner as the taxable income of a nonresident alien. Thus, section 7701(b) does not apply to determine whether a foreign trust is a resident alien. In addition, a foreign trust is not considered to be present in the United States for purposes of section 871(a)(2).

(b) *Applicable law.* The terms of the trust instrument and applicable law must be applied to determine whether the court test and the control test are met.

(c) *In general—(1) Safe harbor.* A trust is a domestic trust if the trust has only United States fiduciaries, as defined in paragraph (e) of this section, the trust is administered exclusively in the United States pursuant to the terms of a trust instrument, and the trust is not subject to an automatic migration provision described in paragraph (d)(2)(v) or (e)(3) of this section.

(2) *Example.* The following example illustrates the rule of paragraph (c)(1) of this section:

Example. A executes a trust instrument for the equal benefit of A's two children, B and C. The trust instrument provides that DC, a State Y corporation, is the only trustee of the trust. Pursuant to the terms of the trust instrument, the trust is administered in State Y, a state within the United States. The trust is not subject to an automatic migration provision described in paragraph (d)(2)(v) or (e)(3) of this section. No person other than DC has any power over the trust. The trust satisfies the safe harbor of paragraph (c)(1) and is a domestic trust.

(d) *The court test—(1) Definitions.* The following definitions apply for purposes of the court test:

(i) *Court.* The term *court* includes any federal, state, or local court.

(ii) *The United States.* The term *the United States* is used in this section in a geographical sense. Thus, for purposes of the court test, the United States includes only the States and the District of Columbia. See section 7701(a)(9). Accordingly, a court within a territory or possession of the United States or within a foreign country is not a court within the United States.

(iii) *Is able to exercise.* The term *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.

(iv) *Primary supervision.* The term *primary supervision* means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision even if another court has jurisdiction over a trustee, a beneficiary, or trust property.

(v) *Administration.* The term *administration* of the trust 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.

(2) *Situations that meet the court test—(i) Uniform Probate Code.* A trust meets the court test if a trust is registered by an authorized fiduciary in a court within the United States under a state statute that has provisions substantially similar to Article VII, *Trust Administration*, of the Uniform Probate Code, 8 Uniform Laws Annotated 1 (West Supp. 1997), available from the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, Illinois 60611.

(ii) *Testamentary trust.* In the case of a trust created pursuant to the terms of a will probated within the United States (other than an ancillary probate), if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States, the trust meets the court test.

(iii) *Inter vivos trust.* In the case of a trust other than a testamentary trust, if the fiduciaries and/or beneficiaries take steps with a court within the United States that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test.

(iv) *A United States and a foreign court are able to exercise primary supervision over the administration of the trust.* If both a United States court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the court test.

(v) *Automatic migration provisions.* Notwithstanding any other provision in this section, a court within the United States is not considered to have primary supervision over the administration of the trust if the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise

the administration of the trust directly or indirectly would cause the trust to migrate from the United States.

(3) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. A, a United States citizen, executes a trust instrument for the equal benefit of A's two United States children. The trust instrument provides that DC, a domestic corporation, is to act as trustee of the trust and that the trust is to be administered in Country X, a foreign country. The trust instrument provides that the law of State Y, a state within the United States, is to govern the trust. Under the law of Country X, a court within Country X is able to exercise primary supervision over the administration of the trust but, as required by the trust instrument, applies the law of State Y to the trust. No court within the United States is able to exercise primary supervision over the administration of the trust. The trust fails to satisfy the court test and therefore is a foreign trust.

Example 2. Trust T owns a single asset, an interest in land located in State Y, a state within the United States. Under the law of State Y, a trust owning solely real property within the state is subject to the primary supervision over the administration of the trust by a court within State Y. The trust satisfies the court test.

Example 3. A, a United States citizen, executes a trust instrument for his own benefit and the benefit of B, his United States spouse. The trust instrument provides that the trust is to be administered in State Y, a state within the United States, by DC, a State Y corporation. The trust instrument further provides that in the event that a creditor sues the trustee in a United States court, the trust will migrate from State Y to Country Z, a foreign jurisdiction, so that no United States court will have jurisdiction over the trust. A court within the United States is not able to exercise primary supervision over the administration of the trust because the United States court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction. Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

(e) *Control test*—(1) *Definitions*—(i) *United States fiduciary.* The term *fiduciary* includes any person described in section 7701(a)(6) and § 301.7701-6(b). In addition, for purposes of this section, any other person who has the power to control one or more substantial decisions of the trust (and therefore has a power ordinarily held by a fiduciary) will be treated as a fiduciary. A person may be treated as a fiduciary even if the trust instrument provides for the person to be relieved of personal liability for violation of duties. A United States fiduciary is a fiduciary that is a United States person within the meaning of section 7701(a)(30). For example, a fiduciary which is a United States corporation owned by a nonresident alien is a United States fiduciary.

(ii) *Substantial decisions.* (A) The term *substantial decisions* means those decisions (other than those described in

paragraph (e)(1)(ii)(B) of this section) that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Substantial decisions include, but are not limited to—

(1) Whether and when to distribute income or corpus;

(2) The amount of any distributions;

(3) The selection of a beneficiary;

(4) The power to make investment decisions;

(5) Whether a receipt is allocable to income or principal;

(6) Whether to terminate the trust;

(7) Whether to compromise, arbitrate, or abandon claims of the trust;

(8) Whether to sue on behalf of the trust or to defend suits against the trust; and

(9) Whether to remove, add, or replace a trustee.

(B) Substantial decisions do not include decisions exercisable by a grantor, unless the grantor is acting as a fiduciary under section 7701(a)(6) and § 301.7701-6(b). In addition, substantial decisions do not include decisions exercisable by a beneficiary, unless the beneficiary is acting as a fiduciary under section 7701(a)(6) and § 301.7701-6(b), that affect solely the portion of the trust in which the beneficiary has an interest. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions made by the fiduciaries.

(iii) *Control.* Control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto the substantial decisions. However, the ability of a grantor (other than a grantor acting as a fiduciary under section 7701(a)(6) and § 301.7701-6(b)) to veto another person's substantial decision does not cause such person to fail to control that substantial decision. In addition, the ability of a beneficiary (other than a beneficiary acting as a fiduciary under section 7701(a)(6) and § 301.7701-6(b)) to veto another person's substantial decision that affects solely the portion of the trust in which the beneficiary has an interest does not cause such person to fail to control that substantial decision.

(2) *Replacement of a fiduciary.* In the event of an inadvertent change in the fiduciaries that would cause a change in the residency of a trust, the trust is allowed six months from the date of the change in the fiduciaries to adjust either

the fiduciaries or the residence of the fiduciaries so as to avoid a change in the residence of the trust. Inadvertent changes in the fiduciaries include the death of a fiduciary or the abrupt resignation of a fiduciary. If the adjustment is made within six months, the trust is treated as retaining its pre-change residence during the six-month period. If the adjustment is not made within six months, the trust residence changes as of the date of the inadvertent change.

(3) *Automatic migration provisions.* Notwithstanding any other provision in this section, United States fiduciaries are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States fiduciaries.

(4) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. A is a nonresident alien individual. A is the grantor and beneficiary of an individual retirement account (IRA) and has the exclusive power to make decisions regarding withdrawals from the IRA and to direct its investments. A is not a fiduciary as defined in paragraph (e)(1)(i) of this section. The IRA has a single United States trustee and no foreign trustees. The United States trustee has the power to control all decisions of the trust other than withdrawal and investment decisions. In this case, decisions regarding withdrawals and the trust's investments are not substantial decisions because these decisions are solely exercisable by the grantor. Therefore, the control test is satisfied because the United States fiduciary controls all substantial decisions.

Example 2. A is a nonresident alien individual. A is the grantor of a trust and has the power to revoke the trust, in whole or in part and revest assets in A. A is the owner of the trust under section 676. A is not a fiduciary as defined in paragraph (e)(1)(i) of this section. The trust has two trustees, B, a United States person and C, a nonresident alien. C's only power is the power to make distributions from the trust and C can exercise this power without authorization from B. In this case, decisions exercisable by A to have trust assets distributed to A are not substantial decisions because these decisions are exercisable by the grantor. However, distribution decisions exercisable by C are substantial decisions. Therefore, the trust is a foreign trust because B does not control all substantial decisions of the trust.

Example 3. Trust has three fiduciaries, A, B, and C. A and B are United States citizens and C is a nonresident alien. The trust instrument directs that C is to make all of the trust's investment decisions, but that A and B may veto C's investment decisions. A and B cannot act to make the investment decisions on their own. The control test is not satisfied because the United States fiduciaries, A and B, do not have the power to make all of the substantial decisions of the trust.

Example 4. Trust has two fiduciaries, A and B, both of whom are United States citizens. The trust instrument provides that C, a foreign corporation,

will serve as an advisor and recommend investments to *A* and *B*. *A* and *B* may accept or reject *C*'s recommendations and can make investments that *C* has not recommended. *A* and *B* control all other decisions of the trust. *A* and *B* delegate to *C* the authority to execute the investment decisions approved by *A* and *B*. The control test is satisfied because the United States fiduciaries control all substantial decisions of the trust.

Example 5. Trust has three fiduciaries, *A*, *B*, and *C*. *A* and *B* are United States citizens and *C* is a nonresident alien. The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. The control test is not satisfied because the United States fiduciaries do not control all the substantial decisions of the trust. No substantial decisions can be made without *C*'s agreement.

Example 6. (i) A trust that satisfies the court test has three fiduciaries, *A*, *B*, and *C*. *A* and *B* are United States citizens and *C* is a nonresident alien. Decisions are made by majority vote of the fiduciaries. The trust instrument provides that upon the death or resignation of any of the fiduciaries, *D*, a nonresident alien, is the successor fiduciary. *A* dies and *D* becomes a fiduciary of the trust. Two months after *A* dies, *E*, a United States person, replaces *D* as a fiduciary of the trust. During the period after *A*'s death and before *E* begins to serve, the trust satisfies the control test and remains a domestic trust.

(ii) Assume the same facts as in paragraph (i) of this *Example 6* except that at the end of the six-month period after *A*'s death, *D* has not been replaced and remains a fiduciary of the trust. The trust became a foreign trust on the date *A* died.

Example 7. Trust has three beneficiaries, *A*, *B* and *C*, all of whom are nonresident aliens. Each beneficiary has the right to receive all of the income from his or her share of the trust for life. Each beneficiary also has a limited power of appointment over his or her respective share of the trust. The trust has only one fiduciary, *D*, a United States citizen. The trust meets the control test because the United States fiduciary controls all substantial decisions of the trust notwithstanding the beneficiaries' powers of appointment over their respective interests.

(f) *Effective date.* This section is applicable to trusts for taxable years beginning after December 31, 1996, and to trusts whose trustee has elected to apply sections 7701(a)(30) and (31) to the trust for taxable years ending after August 20, 1996, under section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755 (26 U.S.C. 7701 note).

Michael P. Dolan,
*Acting Commissioner of Internal
Revenue.*

(Filed by the Office of the Federal Register on June 4, 1997, 8:45 a.m., and published in the issue of the Federal Register for June 5, 1997, 62 F.R. 30796)