

Final Domestic vs. Foreign Trust Status Regulations Include Significant Changes

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"Domestic" and "foreign" trusts are treated differently for many U.S. tax and related compliance law purposes. In addition, as a result of the Small Business Job Protection Act of 1996, substantial penalties apply for failing to file certain information forms in connection with foreign trusts with U.S. settlors or beneficiaries. Our July, 1997 Caribbean Today article discussed the proposed Treasury Regulations which analyzed the domestic v. foreign trust issue from the standpoint of the Internal Revenue Service (the "Service".) On February 1, 1999, the Service issued final Treasury regulations which take into account additional 1997 U.S. tax law changes as well as input from a number of tax professionals. The final regulations in effect require a review of certain trust language used by tax and estate planning practitioners and the possible modification of existing trust documents.

In essence, the most significant changes made by the final regulations are as follows:

1. For a trust to qualify as a "domestic trust", it must meet both the "Court Test" (a U.S. court must be able to exercise primary supervision over the administration of the trust), and the "Control Test" (one or more U.S. persons must have the authority to control all substantial decisions of the trust). The proposed regulations provided a general "safe harbor" for a trust to be treated as a domestic trust, where pursuant to the terms of the trust instrument: (a) the trust only has U.S. fiduciaries; (b) such fiduciaries administer the trust exclusively in the United States; and (c) the trust has no automatic migration or "flee" clause (whereby the trust would be "moved" to an offshore jurisdiction upon the occurrence of one or more specified events.) The final regulations include a somewhat broader Court Test safe harbor if: (a) the trust instrument does not direct that the trust be administered outside of the United States; (b) the trust is actually administered exclusively in the United States; and (c) the trust has no automatic migration provision, except in the case of a foreign invasion of the U.S. or widespread confiscation or nationalization of property in this country. As a result, a "domestic" trust may now satisfy the Court Test safe harbor even though it has foreign fiduciaries, and the trust document need no longer specifically mandate U.S. administration.

2. For purposes of the Control Test, all persons with any power over substantial decisions of the trust must now be taken into account (including a grantor or beneficiary), whether or not such person is acting in a fiduciary capacity (e.g., a trustee). One interesting aspect of this

change is that if the trust's grantor is a foreign person, and he or she retained certain powers to remove, add or replace the trustee, such a power is now deemed to be a "substantial decision" that would make the trust "foreign." In addition, the Control Test will be satisfied if U.S. persons control all substantial decisions by a majority vote. In the event of an inadvertent change in the trust fiduciaries that would otherwise switch a trust's status from domestic to foreign, the period to "cure" this change was extended from six to twelve months.

3. Many practitioners were concerned that under the proposed regulations, if a trust utilized the services of an offshore investment advisor, it may thereby violate the Control Test. The final regulations continue to treat investment decisions as "substantial decisions", but so long as a U.S. fiduciary is able to terminate at will the power of a foreign advisor to make investment decisions, no such violation will occur.

In general, the final regulations are applicable for taxable years ending after February 2, 1999. Provisions are made for certain trusts to elect to continue treatment as domestic trusts or to permit their modification to satisfy the revised Control Test by no later than December 31, 1999. Therefore, existing trusts which potentially may be affected by the revised rules should be carefully examined as soon as possible to determine the appropriate course of action.