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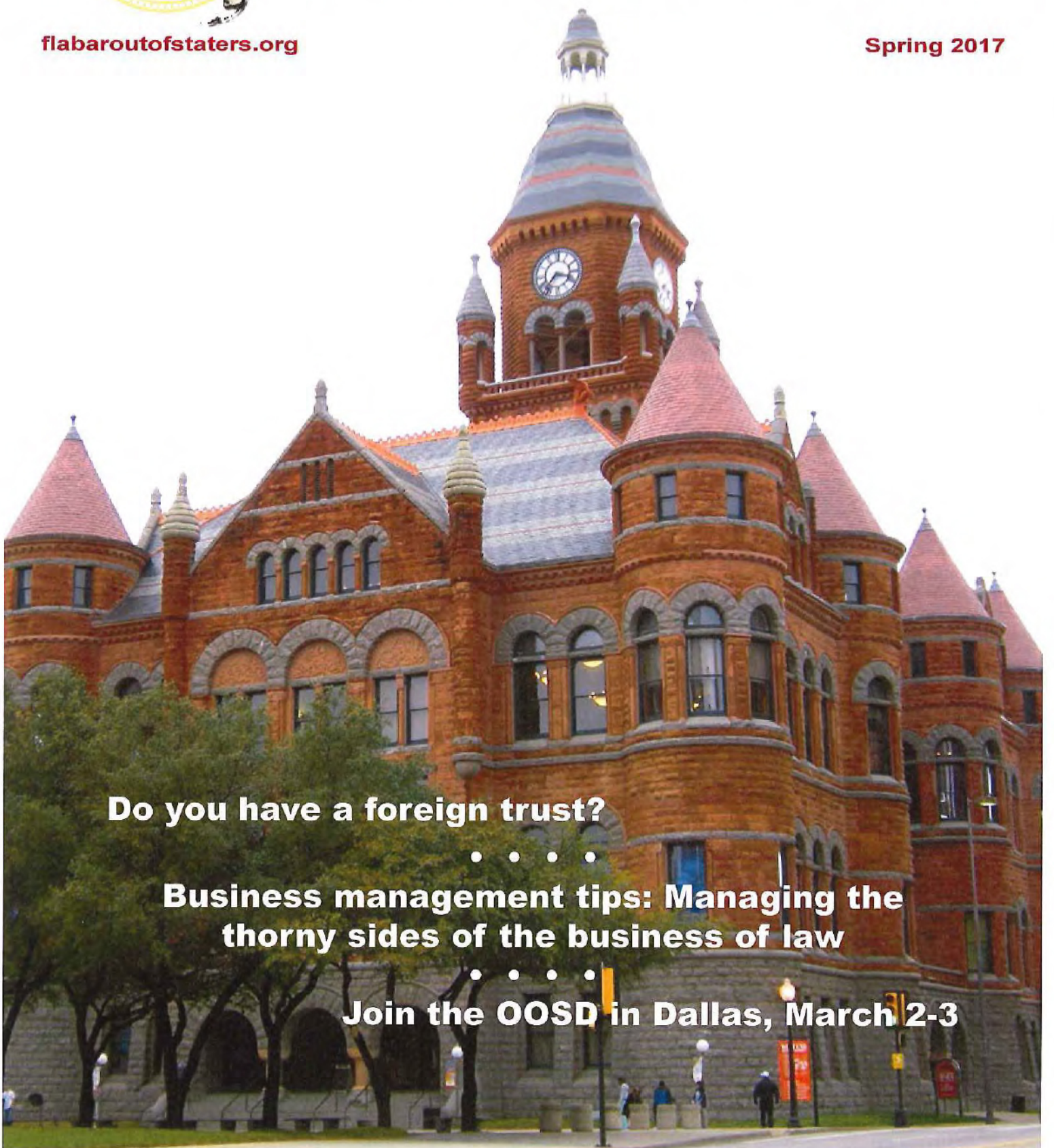
Do you have a foreign trust?

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Do you have a foreign trust?

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The answer in the litigation context may not be black and white because it requires a careful, analytical walk through the applicable sections of the Internal Revenue Code, the appropriate regulations and the nonexclusive examples provided in the regulations and application of that analysis to the fact-specific trust situation and the specific trust provisions. The right answer may result in significant tax

savings to the trust, and the wrong answer might result in potential exposure to the fiduciary that is confronted with a breach of fiduciary duty claim because, for example, taxes were improperly paid by the trust or not properly withheld on behalf of the trust.

A trust considered to be a resident outside of the United States for U.S. income tax purposes (a foreign trust) is taxed under the same rules as a foreign individual. That is, only the U.S. dividends earned by a foreign trust are taxed. 26 U.S.C. § 1441. The U.S. dividends are taxed at 30%, which tax is to be withheld by the last U.S. distributor of the income. *Id.*

The withholding is generally done by the custodian prior to remitting the balance of the dividend to the trust. If that is done properly, a foreign trust need not file a U.S. income tax return.¹

Accordingly, it is important to know whether the trust you are dealing with is a foreign trust. The trustees, trust counsel and trust accountants of any trust with a non-U.S. person as a trustee should evaluate the trust to determine whether it is a foreign trust, both at inception and any time there is a change in the number of trustees, such as upon the death, resignation or removal of a trustee.

A trust's residence is determined under rules called the "court test" and the "control test." 26 U.S.C. §§ 7701(a)(30), 7701(a)(31); 26 C.F.R. § 301.7701-7. Unless *both* tests are satisfied, the trust is a foreign trust.

The court test is satisfied if "a court within the United States is able to exercise primary supervision over the administration of the trust." 26 C.F.R. § 301.7701-7(a)(1)(i). This test is met "if – (i) The trust instrument does not direct that the trust be administered outside of the United States; (ii) The trust in fact is administered exclusively in the United States; and (iii) The trust is not subject to an automatic migration provision ..." 26 C.F.R. § 301.7701-7(3)(c). Satisfaction of the court test, from an evidentiary standpoint, is not difficult. For example, proof might consist of evidence that the trustees meet in the United

States and accountings have been filed in a U.S. court that has taken jurisdiction of the subject trust.

The control test is satisfied if "[o]ne or more United States persons have the authority to control all substantial decisions of the trust." 26 C.F.R. § 301.7701-7(a)(1)(ii). The regulations found in Section 301.7701-7(d)(1)(ii) set forth a list of the types of decisions considered to be "substantial decisions," including removal of a trustee or filling a trustee vacancy. If a foreign person controls any one of those substantial decisions because of an express veto power or even a circumstantial veto power based upon the number of trustees and a majority vote requirement, the trust can be persuasively argued to be foreign. The list is not exclusive, and the examples provided by the regulations are neither exhaustive nor a model of clarity. For example, when there are three trustees, two of whom are U.S. persons and one of whom is a non-U.S. person and one of the U.S. trustees dies, leaving one U.S. trustee and one non-U.S. trustee, and the trust requires trustee decisions to be made by majority vote, both trustees must agree on a substantial decision. The trust can be argued to be foreign because that substantial decision is not controlled by a U.S. person. Preamble to Final Regulations (TD 8813, Taxpayer classifications—treatment as United States person – trusts). Code § 7701, 2/02/1999, example at Section B(3).

Foreign trust continued

“A trust is a United States person for purposes of the Internal Revenue Code (Code) on any day that the trust meets both the court test and the control test.” 26 C.F.R. § 7701-7(a)(2). Under this “daily test,” it is appropriate to look at a trust on a given day to see whether there is U.S. or foreign control; however, the “power” in a foreign person to control a substantial decision is enough to render the trust foreign that day regardless of whether the occasion to exercise that power has yet arisen. For example, if a foreign person has the power under the trust to control legal claims, the trust is foreign whether or not a claim is pending on a given day. Otherwise, the trust would be foreign if a claim arose in January, domestic in

February after the claim was settled and foreign again in March if another claim arose, which would be nonsensical.

Clearly, the determination of the residency of a trust for U.S. income tax purposes is an important as well as a complex one. The analysis should be undertaken by a sophisticated tax professional whenever a trust has a non-U.S. person as a trustee, not only at inception of the trust, but also whenever the number of trustees changes such that the balance of power could shift to the non-U.S. trustee for any substantial decision. Trusts stating an intention to be a foreign trust, requiring that at least one trustee always be a non-U.S. person and giving the foreign trustee an express veto power over a specific substantial decision are more easily

established to be foreign trusts in a litigation context. Expert testimony may be required to prove that a trust is foreign where a trustee just happens to be a non-U.S. person and his or her controlling veto power is circumstantial, rather than express, a fact that may be proven by trust counsel through demonstrative exhibits reflecting the interplay of the trust provisions, the regulations and the analysis of the expert who has concluded that the trust is a foreign trust.

Endnote

1 U.S. settlors and U.S. beneficiaries of foreign trusts may face reporting requirements/penalties and/or adverse U.S. income tax consequences and should consult with their tax professionals concerning any tax issues related to a foreign trust.