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Michelle B. Graham is a shareholder at Greenberg Traurig LLP in San Diego.

In this article, Graham proposes an entity classification election that would provide clarity to purpose trusts and other foreign structures such as foundations and nonstock corporations that are functioning as ordinary trusts, and she suggests the addition of two scenarios to satisfy the judicial test for determining whether trusts are domestic or foreign.

This article is one in a series of proposals sponsored by the California Lawyers Association Taxation Section and presented to various policymakers and government officials. The comments in it reflect the individual views of the author who prepared them and not the position of the California Lawyers Association or persons who provided feedback or comments.

Although the author of this article might have clients affected by its subject matter and have advised them on the applicable law, no participant has been specifically engaged by a client to participate in this project.

I. Introduction

This article proposes an entity classification election for purpose trusts and other foreign structures such as foundations and nonstock corporations that are functioning as ordinary trusts. This would provide clarity, simplify filing requirements, and reduce the administrative burden on the IRS. The first part of the article pertains to purpose trusts and other foreign structures that function similarly to U.S. ordinary trusts and proposes allowing them to make an election to be classified as a trust for U.S. tax purposes. The second part pertains to structures that are ordinary trusts under federal law, but there is uncertainty as to whether they are foreign or domestic. The proposal would allow those trusts to elect to be classified as a U.S. trust for all federal tax and reporting purposes. No election would be allowable to have those trusts classified as foreign trusts.

The first suggested change would involve amending reg. section 301.7701-4 in two ways: (1) to provide that trusts created for a purpose rather than for the benefit of one or more ascertainable beneficiaries (such as pet trusts, cemetery trusts, charitable trusts, and noncharitable purpose trusts as described in section 409 of the Uniform Trust Code, which has been adopted in 36 states) may be ordinary trusts despite the absence of ascertainable beneficiaries; and (2) by adding a new provision that a foreign entity or arrangement (hereinafter referred to as a structure) that functions similarly to a U.S. ordinary trust as described in reg. section 301.7701-4(a) can elect to be classified as a trust for federal income tax purposes, similar to how an eligible business entity may elect tax classification under reg. section 301.7701-3(a).

The second suggested change would be to amend reg. section 301.7701-7(c)(4)(i) to provide two additional situations for trusts to satisfy the court test for purposes of determining whether they are domestic or foreign: (1) a trust satisfies the control test (discussed below) and elects to be classified as a U.S. person for federal tax purposes, and (2) a trustee agrees and acknowledges that a court within the United States will have primary supervision over the administration of the trust. In either situation, the trust would satisfy the court test.

II. Current Law

A. Election for Entities Comparable to a U.S. Trust

In the United States, trusts are commonly used in estate planning. In contrast, many civil law countries do not recognize trusts and legislate similar planning-type entities or arrangements (structures) to accomplish similar objectives. Many of these structures do not exist in the United States, so each must be analyzed under the laws of the United States and the foreign country to determine how they will be treated for U.S. tax purposes.

In the case of a foreign structure, it may be difficult to determine how it should be treated for U.S. tax and reporting purposes without an extensive review and analysis. A complex analysis is often required that includes reviewing and interpreting foreign law and the formation and governing documents of the structure to determine whether it is an ordinary trust under reg. section 301.7701-1-4(a). The governing documents of the structure may need to be translated into English and advice will likely be required from counsel in the country in which the structure was formed regarding various legal and tax elements. This analysis can be very expensive and time-consuming.

The starting point of the analysis is reg. section 301.7701-1(b), which provides that the classification of organizations that are recognized as separate entities is determined under reg. sections 301.7701-2, 301.7701-3, and 301.7701-4, unless a provision of the IRC calls for special treatment of that organization. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as a trust under local law.

In general, an arrangement will be treated as an ordinary trust if it can be shown that the purpose of the arrangement is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and therefore are not associates in a joint enterprise for the conduct of business for profit. If an entity has both associates and a business purpose, it cannot be classified as a trust for federal income tax purposes.

Other arrangements are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but they are not classified as ordinary trusts for purposes of the code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been conducted through business organizations that are classified as corporations or partnerships under the code.

Reg. section 301.7701-4(a) seems to treat an arrangement as a trust only if its purpose is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries. This definition is out of date. The laws of many states recognize trusts created for any lawful purpose as valid even if they have no ascertainable beneficiary. See, for example, section 409 of the Uniform Trust Code. However, reg. section 301.7701-4(a) seems to require that there be beneficiaries in order for an arrangement to be taxable as a trust. At least three authorities indicate that this may not be the view of the IRS: Rev. Rul. 58-190, 1958-1 C.B. 15 (cemetery trust); Rev. Rul. 76-486, 1976-1 C.B. 192 (pet trust); and INFO 2015-0039 (gun trust). The regulations should be amended to provide clear guidance regarding the proper classification of purpose trusts.

In civil law countries in which trusts are not typically recognized, there are structures that may hold similar attributes to a trust, in that they are formed to protect or conserve the property for designated beneficiaries or to serve noncommercial purposes. A few examples of foreign entities that may be classified as a trust for U.S. tax purposes are stiftungs, foundations, waqfs, fideicomisos, and usufructs. Moreover, two states (New Hampshire and Wyoming) have adopted legislation that presents similar uncertainties regarding how foundations will be classified for U.S. tax purposes. Delaware allows nonstock corporations to be formed for charitable or noncharitable purposes that might function in a manner similar to a purpose trust, but the tax classification is likely to be a corporation.

In AM 2009-012 the IRS Office of Chief Counsel analyzed the tax classification of a Liechtenstein anstalt and stiftung. It noted that in most situations, the primary purpose for the establishment of an anstalt is to conduct an active trade or business and to distribute the income and profits to the beneficiaries of the anstalt. The memorandum concluded that anstalts generally are not properly treated as trusts under reg. section 301.7701-4(a) because in most cases their primary purpose is to actively carry on business activities. Liechtenstein anstalts are thus generally classified as business entities under reg. section 301.7701-2(a).

Based on the information submitted in the memorandum it was also determined that Liechtenstein stiftungs generally are properly treated as trusts under reg. section 301.7701-4(a) because in most cases the stiftung's primary purpose is to protect or conserve the property transferred to it for the stiftung's beneficiaries; it is usually not established primarily for actively carrying on business activities. However, if the facts and circumstances indicate that a stiftung was established primarily for commercial purposes, as opposed to the purpose of protecting or conserving property on behalf of the beneficiaries, the stiftung may be properly classified as a business entity under reg. section 301.7701-2(a). Thus it is important to analyze the facts and circumstances of each case to determine whether a particular stiftung was established to protect and conserve property or was created as a device to carry on a trade or business.

In *Estate of Swan*,[1] the court determined that the assets of a Swiss stiftung and a Liechtenstein stiftung should be includable in the decedent's gross estate. The court considered the application of the federal estate tax under prior section 811(d) (now section 2036) and concluded that the stiftungs were comparable to trusts for U.S. estate tax purposes, rather than corporations. Because the stiftungs were comparable to trusts, the court held that transfers to them were encompassed by the broad statutory language "by trust or otherwise" in former section 811.

In *Rost*, the Fifth Circuit affirmed the district court and held that a Lichtenstein stiftung created by a U.S. person was a foreign trust for tax reporting purposes and that the trust and grantor were liable for substantial penalties for failure to file a timely and correct Form 3250, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," and Form 3250-A, "Annual Information Return of Foreign Trust With a U.S. Owner."[2]

U.S. taxpayers have long questioned whether Mexican fideicomisos (which means "trust" in Spanish) are trusts for U.S. tax purposes. If a fideicomiso is considered a trust for U.S. tax purposes, a Form 3520 and Form 3520-A likely will be required, along with a Form 8938, "Statement of Specified Foreign Financial Assets," and possibly Form FinCEN Report 114, "Report of Foreign Bank and Financial Accounts." In Rev. Rul. 2013-14, 2013-26 IRB 1267, the fideicomiso in the ruling was determined not to be a trust based on its terms. The fact that the trustee did not engage in activity other than holding title to the land was key in that decision. The arrangement was more like a nominee arrangement than a trust. The determination of whether a fideicomiso is a trust or more like a nominee arrangement is based on the facts and circumstances. For fideicomisos that do not merely hold title to real property in Mexico, Rev. Rul. 2013-14 will not apply and taxpayers will face determining how the fideicomiso will be classified for U.S. tax purposes.

Even when there is guidance on how an entity may be treated, an extensive analysis is necessary, and the conclusion remains uncertain. The penalties taxpayers face for incorrectly classifying a foreign structure can be significant.

After many years of debate over the proper classification of business entities, the IRS implemented check-the-box regulations in 1996 that allow certain (eligible) business entities to make an election to be treated as a corporation or partnership-disregarded entity for federal tax

[1] *Estate of Swan v. Commissioner*, 247 F.2d 144 (2d Cir. 1957).

[2] *Rost v. United States*, 44 F.4th 294 (5th Cir. 2022), *aff'g* No. 1:19-cv-00607 (W.D. Tex. 2021).

purposes. An eligible entity can make an election to change its default tax classification by filing Form 8832, "Entity Classification Election," with the IRS. A trust is not an eligible entity under reg. section 301.7701-3(a). T.D. 8697 explains:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

The determination of whether a structure will be classified as a trust is based on the governing documents and appliable law, along with the specific facts and circumstances. When a determination such as this is subjective, different conclusions can be reached. The guidance in this area consists of case law, private letter rulings, and a memorandum by IRS counsel. While helpful, the guidance is fact-specific and does not give taxpayers certainty about entities that should be classified as trusts, unlike the certainty the check-the-box elections afford business entities. Taxpayers with foreign structures similar to trusts should be afforded the same certainty that taxpayers with eligible business entities have concerning the tax classification of those entities or arrangements. Thus, an eligible trust — defined as an entity or arrangement the primary purpose of which is to protect or conserve the property for the beneficiaries (who are not associates) and that is not established primarily for actively carrying on business activities — should be able to make an election to be classified as an ordinary trust for U.S. tax purposes, similar to how an eligible business entity makes a check-the-box election. Further, reg. section 301.7701-4 should be amended to confirm that purpose trusts valid under applicable state law may be classified as ordinary trusts despite the fact that they have no ascertainable beneficiary.

B. Trust Election to Satisfy the Court Test

The second part of this article pertains to entities that are clearly classified as ordinary trusts for U.S. tax purposes (or that elect to be treated as such as recommended above), but there is uncertainty about whether they should be classified as foreign or domestic trusts. The Small Business Job Protection Act of 1996 established a two-part objective test for determining the situs of a trust, which was a vast improvement to the facts and circumstances test that previously existed. The law added section 7701(a)(30)(E), which states that a trust will be treated as a domestic trust for tax purposes if (1) a court within the United States is able to exercise primary supervision over the administration of the trust (the court test), and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust (the control test). The applicable regulations provide that a trust will meet the court test if: (1) the trust instrument does not direct that the trust be administered outside of the United States; (2) the trust is administered exclusively in the United States; and, (3) the trust is not subject to an automatic migration provision (a provision that causes the situs of the trust to change if a court attempts to exercise jurisdiction).

Final regulations were issued 25 years ago that went into effect on February 1, 1999, providing guidance on determining whether a trust is a U.S. person (domestic trust) or a foreign trust. Recognizing the difficulty in determining when a trust would meet the court test, the final regulations included safe harbor provisions.

Because the primary concern addressed by the safe harbor is the difficulty in determining whether a court in a particular state would assert primary supervision over the administration of a trust if that trust had never appeared before a court, the final regulations provide a safe harbor only for the court test. A trust that satisfies the safe harbor, therefore, would also need to meet the control test to be a domestic trust.

The final regulations clarified that the scenarios presented for meeting the court test did not constitute an exclusive list. The purpose of setting forth specific situations was to provide bright-line rules that would give taxpayers certainty of treatment. The four bright-line rules that satisfy the court test are shown in these scenarios:

- when a trust is registered by an authorized fiduciary or fiduciaries of the trust in a court in the United States under a state statute that has provisions substantially similar to Article VII, Trust Administration, of the

Uniform Probate Code, 8 Uniform Annotated 1 (West Supp. 1998);

- in the case of a trust created under 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;
- in the case of a trust other than a testamentary trust, if the fiduciaries or beneficiaries take steps with a court in the United States that cause the administration of the trust to be subject to the primary supervision of the court; and
- when a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust.

The first three bright-line rules are very limited. As of this writing, fewer than a dozen states allow for trust registration. The second bright-line rule only comes into play if the trust is testamentary and the third bright-line rule requires that steps be taken in the United States that cause the administration of the trust to be subject to the primary supervision of the court, which can be expensive, time-consuming, and often completely unnecessary. The fourth bright-line rule is helpful, but it still requires a determination of whether a U.S. court will have primary supervision over the administration of the trust. How is a taxpayer to know whether a court in the United States will be able to exercise primary supervision over a trust, particularly if the U.S. trustee resides outside the country or the trust holds substantial foreign assets? The whole purpose behind the control test and court test was to provide taxpayers with certainty.

Because of the uncertainty concerning satisfaction of the court test, this article proposes the addition of two bright-line rules to reg. 301.7701-7(c)(4)(i) that would allow a trust to make an election to be treated as a U.S. person for federal income tax purposes and thereby satisfy the court test. The first option would find the court test satisfied if: (1) the trust agreement includes language that the trust is intended to be classified as a domestic trust for U.S. tax and reporting purposes, and (2) the trustee is obligated to submit to the jurisdiction of a U.S. court that will have primary supervision over the administration of the trust. The second option would allow the trustee to make an election to be classified as a domestic trust, similar to how an eligible entity elects tax classification on Form 8832 or a non-U.S. citizen spouse elects to be treated as a U.S. person for U.S. tax purposes.

III. Problems Addressed

The proposal would (1) provide certainty as to when a foreign structure that functions similarly to an ordinary trust will be classified as a trust under U.S. laws, (2) clarify that purpose trusts may qualify as ordinary trusts for U.S. tax purposes, (3) add certitude about whether a trust is treated as a foreign trust or a domestic trust when it is unclear whether the trust has satisfied the court test, and (4) allow trusts that meet the control test the ability to elect to be classified as domestic (U.S.) trusts.

The proposal calls for a simple election for trusts to make that would allow them to be treated as domestic trusts for U.S. tax and reporting purposes by including required language in the trust agreement or trust deed. This language would state that the trust is intended to be classified as a domestic trust for U.S. tax and reporting purposes and by the trust instrument or trust deed or other instrument in which the trustee agrees and acknowledges that a U.S. court will have primary supervision over the administration of the trust.

IV. Merits of Proposal

Foreign entities were included in the existing check-the-box regulations because it was understood that foreign entity classification was often more difficult and expensive to resolve than domestic entity classification. Further, the classification of foreign entities is more uncertain and more likely to frustrate the commercial expectations of the owners of the foreign entity. Thus, the simplification process under the check-the-box regulations was thought to more than justify Treasury's decision to extend the check-the-box regulations to eligible foreign entities.[3] This article proposes that the regulations be extended to include foreign entities that are not

[3]*See* Notice 95-14, 1995-1 C.B. 297.

businesses but rather function more like trusts, as they run into the same complexities and uncertainties that businesses face.

The proposal would comply with the legislative intent behind the enactment of section 7701(a)(30). Except for granting trusts an election to be taxed as U.S. trusts, the proposal does not seek a change in the law but rather attempts to add clarity to two areas that are uncertain, as the existing analysis is based on the facts and circumstances. The proposal will not negatively affect tax revenues because it seeks to devote the IRS's resources to other examinations that may prove more fruitful.

V. Collateral Consequences

The proposal will not affect other tax laws, as it seeks to provide certainty to the tax classification of certain foreign entities and trusts. Adopting it, however, would require amendments to reg. section 301.7701-4(a) and reg. section 301.7701-7(c)(4)(i), along with guidance on how a trustee can make the elections described above. It will also decrease the number of audits the IRS must conduct. The proposal seeks to efficiently dispose of audits by using existing informal mail audit procedures.

VI. Feasibility

The proposal is feasible and relatively uncomplicated. Further, it does not seek to implement a new statute or code section or to modify the existing statute. Rather, it simply requires additional language under the regulations to clarify the tax classification of arrangements. These proposed clarifications of existing law are politically and economically feasible, as they provide clearer standards for the tax classification of arrangements and foreign entities that function like trusts and ordinary trusts. The proposal will also facilitate greater and more consistent administrative enforcement.[4] ■

[4]The views expressed herein are those of the author and do not necessarily reflect the views of anyone else. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or an opinion provided by the author to the reader. The reader is also cautioned that this material may not be applicable to, or suitable for, the reader's specific circumstances or needs, and may require consideration of nontax and other factors if any action is to be contemplated. The reader should contact his or her tax adviser before taking any action based on this information. The author assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect the information contained herein.