

MEMO# 12756

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IRS ISSUES PROPOSED REGULATIONS ON CLASSIFICATION OF QUALIFIED PLAN AND IRA TRUSTS AS DOMESTIC TRUSTS

[12756] October 19, 2000 TO: PENSION COMMITTEE No. 78-00 RE: IRS ISSUES PROPOSED REGULATIONS ON CLASSIFICATION OF QUALIFIED PLAN AND IRA TRUSTS AS DOMESTIC TRUSTS The Internal Revenue Service has issued proposed regulations amending the regulations that define "domestic trusts" and "foreign trusts" for federal tax purposes. Specifically, the proposed regulations would include "group trusts" consisting of qualified plan trusts and IRA trusts within a special category of trusts deemed to satisfy the "control test" under the domestic trust definition, if U.S. trustees control all of the substantial decisions of the trust made by its trustees. The proposed regulations also clarify the term "U.S. fiduciary" under the control test to mean a U.S. trustee holding legal title to the trust assets. Comments to the proposed amendments must be received by January 10, 2001. A public hearing on the proposed regulations also is scheduled for January 31, 2001.¹ As you are aware, a qualified retirement plan trust must be maintained at all times as a domestic trust in the United States. IRA trusts are subject to similar requirements. Code section 7701(a)(30) provides that a trust will be treated as a domestic trust if (i) a court within the U.S. is able to exercise primary supervision over the administration of the trust (court test), and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust (control test). Treasury regulation section 301.7701-7(d), which provides guidance on the application of the control test, generally looks to all persons with any power over substantial decisions of the trust, whether acting as a fiduciary or not, in determining whether the control test is met. Certain employee benefit trusts, however, are subject to a "special control test" under which specified trusts are deemed to satisfy the control test if United States fiduciaries control all of the substantial decisions of the trust that are made by the trustees or fiduciaries.² The proposed regulations clarify that the term "fiduciary" under the special control test means the

1 Requests to speak at the hearing must be submitted by the comment deadline. 2 Under the current regulations, the following employee benefit trusts are qualify under the "special control test": (1) a qualified trust described in section 401(a); (2) a trust described in section 457(g); (3) a trust that is an individual retirement account described in section 408(a); (4) a trust that is an individual retirement account described in section 408(k) or 408(p); (5) a trust that is a Roth IRA described in section 408A; (6) a trust that is an education individual retirement account described in section 530; and (7) trust that is a voluntary employees' beneficiary association described in section 501(c)(9). Treas. Reg. section 301.7701-7(d)(1)(iv). 2trustee holding legal title to the trust assets on behalf of those with beneficial interests, rather than ERISA's definition of fiduciary.³ The proposed regulations also add "group trusts" described in Revenue Ruling 81-100,⁴ which consists of qualified plan trusts and IRA

trusts, as a category of trusts that qualify under the special control test. The IRS noted that because these trusts are required to be created or organized in the United States and are subject to other detailed requirements, they are similar to the other categories of employee benefit trusts listed in Treasury regulation section 301.7701-7(d)(1)(iv), and therefore, should be subject to the special control test. In addition, the proposed regulations add investment trusts classified as trusts under Treasury regulation section 301.7701-4(c)(1) as a category of trusts that qualify under the special control test, if several conditions are met.⁵ These trusts are subject to reporting requirements as domestic grantor trusts, and each investor must report the items of income, deduction and credit that are attributable to the investor's portion of the trust. The proposed regulations also clarify that trusts created or organized in Puerto Rico forming part of a pension, profit-sharing or stock bonus plan may continue to elect to have the trust treated as a trust created or organized in the U.S. for purposes of Code section 401(a). Finally, the regulations are proposed to be applicable to trusts for taxable years ending on or after the date the final regulations are published. It is anticipated that the final regulations will provide that trusts will be able to rely on the final regulations for taxable years beginning after December 31, 1996.⁶ Thomas T. Kim Assistant Counsel Attachment (in .pdf format) 3 For example, where the sole trustee of a trust is a U.S. person, that trust qualifies under the special control test, notwithstanding any powers held by non-U.S. persons to direct the actions of the trustee (see example 5 of the proposed regulations). 4 Revenue Ruling 81-100 provided that trusts that are part of qualified retirement plans and IRAs may pool their assets in a "group trust" without affecting the tax-exempt status of the separate trusts. 5 The conditions to qualify under the special control test are as follows: (i) all trustees must be U.S. persons and at least one of the trustees is a bank, U.S. government-owned agency or U.S. government-sponsored enterprise, (ii) all sponsors (persons who exchange investment assets for beneficial interests with a view to selling the beneficial interests) are U.S. persons, and (iii) the beneficial interests are widely offered for sale primarily in the U.S. to U.S. persons. An investment trust that satisfies these conditions would be deemed to satisfy the control test even though one or more investors may be foreign persons with the power to make a substantial decision of the trust. 6 The Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997 established the current statutory test, effective December 31, 1996, for determining whether a trust is a domestic trust. Prior to the statutory change, whether a trust was a domestic trust generally turned on a facts and circumstances determination based on if the trust was a resident trust and was subject to the continuous jurisdiction of the U.S.