FILING REQUIREMENTS UPON CONVERSION OF A TRUST BETWEEN FOREIGN AND DOMESTIC STATUS

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INTRODUCTION

Whether a trust is categorized as a U.S. domestic trust or a foreign trust leads to different tax consequences and different filing obligations. This leads to the following questions: Which tax return must be filed when a trust is converted from a U.S. domestic trust to a foreign trust, and which applies when a foreign trust is converted to a U.S. domestic trust? A Chief Counsel Advice Memorandum, C.C.A. 201432022 issued on August 8, 2014, provides guidance on filing requirements in these fact patterns. Though it stated the obvious, the C.C.A. still leaves questions open, in particular with respect to grantor trusts. This article summarizes the conclusion reached by the C.C.A. and addresses issues for which clarification was not provided.

C.C.A. 201432022

In approaching the issue, the C.C.A. began by outlining the rules under which the filing status of a trust is determined for U.S. federal income tax purposes.

U.S. Trust versus Foreign Trust – General Tax Rules

Domestic trusts, like U.S. citizens and residents, are taxed on worldwide income, whereas foreign trusts, like nonresident aliens, are taxed only on U.S.-source income and income effectively connected with the conduct of business in the United States.

Generally, a trust is domestic if it is subject to primary supervision by a U.S. court and all substantial decisions are made by U.S. persons, the so-called "Court Test" and the "Control Test," respectively, under the regulations.[1] Under the Court Test, a trust is a U.S. person ("Domestic Trust") if a "court within the United States is able to exercise primary supervision over [its] administration." The Control Test requires that U.S. persons have "authority to control all substantial decisions of the trust." "Substantial decisions" of a trust are those nonministerial decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law. These include:

Whether and when to distribute income or corpus;

- The amount of any distributions;
- The selection of a beneficiary;
- The power to make investment decisions;

[1] Treas. Reg. §301.7701-7(a).

- Whether a receipt is allocable to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate, or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust;
- Whether to remove, add, or replace a trustee; and
- Whether to appoint a successor trustee or trustees.[2]

Examples of ministerial decisions include bookkeeping, collection of rents, and the execution of investment decisions made by others.[3]

If both of these requirements are not met, a trust is a "Foreign Trust."[4] The application of both tests depends on the "terms of the trust instrument and applicable law."[5] The tests are applied daily, and a trust is a Domestic Trust on each day that it meets both tests. The Court and Control Tests were enacted in 1996 to provide "an objective test for determining whether a trust is foreign or domestic."

Filing Requirements for U.S. versus Foreign Trusts

A Foreign Trust is treated like a nonresident alien individual and must file Form 1040NR to report income. A Domestic Trust must file Form 1041. An income tax return is required if the Domestic Trust has:

- Any taxable income for the tax year;
- Gross income of $600 or more for the tax year, whether or not it has any taxable income; or

A beneficiary who is a nonresident alien.

In determining whether the trust has gross income of $600 or more, income taxable to a grantor as owner of the trust is viewed as part of the trust's income. However, certain grantor trusts do not file Form 1041, as explained below under "Open Issues."

I.R.S. Counsel's Conclusion on Conversion Year Filings

According to the C.C.A., a trust that is a U.S. person on the last day of the tax year must file Form 1041 and enter "Dual-Status Return" across the top. The trust should also attach Form 1040NR as a schedule showing the income for the part of the year during which it was a Foreign Trust. If a trust is a Foreign Trust on the last day of the tax year, it must file Form 1040NR with "Dual-Status Return" written across the top and attach Form 1041 as a schedule showing the income for the part of the year during which it was a Domestic Trust.

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2 Treas. Reg. §301.7701-7(d)(1)(ii).

3 Id.

4 Code §§7701(a)(30)(E), 7701(a)(31)(B), as amended by Pub. L. No. 104-188, §1907, 110 Stat. 1755 (1996) (applicable for taxable years beginning after 1996 or, at trustee's election, for taxable years ending after August 20, 1996).

5 Treas. Reg. §301.7701-7(b).

OPEN ISSUES

"Trusts that do not fall under the Grantor Trust rules deflect tax liability away from the grantor to either the beneficiaries or the trust."

The C.C.A. refers only to the filing obligations of the trust itself. Generally, these rules are applicable to so-called "Non-Grantor Trusts," *i.e.*, trusts that are either simple or complex trusts. Trusts that do not fall under the Grantor Trust rules deflect tax liability away from the grantor to either the beneficiaries or the trust, generally depending on whether income is distributed in the year received (a simple trust) or accumulated by the fiduciary (a complex trust).[6] This result is accomplished by including all of the income on the trust's return, with a deduction for amounts taxable to the beneficiaries, who then pick up these amounts for inclusion on their own returns. Since the trust is viewed as a pass-through, *pro tanto*, distributed income usually retains its original character (*e.g.*, as tax-exempt interest, capital gain, or foreign-source income) in the hands of the beneficiaries. Each must report his or her *pro rata* portion of specially treated items, unless the governing instrument applies a different allocation.

The C.C.A. does not address that in specific circumstances it is not the trust per se that is taxable, but rather it is the grantor who is taxable on trust income as though the grantor retained the property instead of creating a trust (the so-called "Grantor Trust"). Hence, in the latter scenario, specific filing obligations that may apply to the grantor remain unclear, in particular with respect to years where the status of a trust changes from domestic to foreign, non-grantor to grantor, foreign to domestic, and grantor to non-grantor. The following addresses some of these circumstances including a brief description of the statutory framework.

Change from Grantor to Non-Grantor and Domestic to Foreign Trusts and Vice Versa

Grantor v. Non-Grantor Trusts – General Tax Rules

Many years ago, the Grantor Trust rules, which when applicable prevail over the rules governing ordinary trusts, subjected the grantor to taxation only if the grantor could revoke the trust or reclaim the income. However, in a series of cases leading up to the landmark decision in *Helvering v. Clifford*,[7] the courts held that the grantor could be taxed, even in the absence of a power to revoke, if the grantor retained significant control over beneficial enjoyment of trust income or corpus. These "Clifford Trust" principles, which required determination on a case-by-case basis, were replaced subsequently by Treasury Regulations that set forth relatively precise rules. In 1954, these regulations were superseded by the detailed statutory rules of Code §§671-677.

Under these provisions, a trust is treated as a Grantor Trust if the grantor retains a reversionary interest with an initial value that is greater than 5% of the value of the trust or specified rights to control beneficial enjoyment of the corpus or income or if the grantor retains or vests in a non-adverse party unusual administrative powers of a non-fiduciary character. In addition to these rules, a person other than a grantor is treated as owner of trust property under Code §678 if the person has power to vest corpus or income in himself (so-called "Mallinckrodt Trusts").

In addition, Code §679 treats a U.S. person as the grantor of a Foreign Trust even

[6] Treas. Reg. §301.7701-7(a)(2).

[7] *Helvering v. Clifford*, 309 U.S. 331 (1940).

in the absence of an interest in or power over trust assets or beneficiaries, if the trust has one or more U.S. beneficiaries. Under Code §679, a U.S. person who transfers property, directly or indirectly, to a Foreign Trust is treated as owning the portion of the trust that is attributable to the transferred property if a U.S. person is a beneficiary of that portion. If a nonresident, non-citizen individual becomes a U.S. resident within five years after having transferred property to a Foreign Trust, Code §679 applies as though the person, on his or her residency starting date, transferred to the trust the property then held by the trust that is attributable to the transferred property, including an appropriate share of any income accumulated in the trust. Also, if a U.S. citizen or resident transfers property to a Domestic Trust that subsequently becomes a Foreign Trust, the transferor, if then living, is treated as transferring to a Foreign Trust the portion of the trust that is attributable to the transferred property.

Grantor Trust Filing Obligations and Exception

While a Grantor Trust is a legal trust under applicable state law, it is not recognized as a separate taxable entity for federal income tax purposes due to the grantor or another person having retained substantial dominion or control over the trust. The grantor or other person is treated as owner of the trust and is taxed on all or part of its income. Nevertheless, except in the case of certain revocable trusts, a Grantor Trust may be required to file Form 1041.

For tax purposes, the income is ordinarily treated as though it had been received by the grantor and then transferred by nontaxable gift to the trust beneficiary. A beneficiary who reports the amount as taxable income on the mistaken assumption that the trust is not a Grantor Trust is entitled to a refund of the tax when it becomes clear that the grantor is the proper taxpayer.

The owner of a Grantor Trust (or of a part of such a trust) is directly taxable on that part of the trust income that he or she is deemed to own and is entitled to the deductions and credits allocable to it. Consequently, the trustee should not report such income, deductions, or credits on Form 1041. Instead, the trustee should attach to Form 1041 a separate statement showing the owner's name, taxpayer identification number ("T.I.N."), and address; and the trust income, deductions, and credits owned by that owner. Those items will then be reported by the grantor or other person on his return as income, deductions, and credits, as though the trust were not in existence. If the owner's tax year differs from that of the trust, the statement should contain the information needed to assign the items of income, deduction, and credit to the proper tax year of the owner.

Instead of filing a Form 1041 and attaching a statement, the trustee of a Grantor Trust, all of which is owned by one or more grantors or other persons, can elect one of three optional reporting methods. The reporting options available depend on whether the trust is treated as owned by one grantor or by two or more grantors. If the trust is treated as owned by one grantor, the trustee may choose between two alternative methods of reporting.[8]

The trustee is required to furnish to all payors either (i) the grantor's name and T.I.N., and the address of the trust, under the first alternative, or (ii) the name, T.I.N., and address of the trust, under the second alternative.

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8 Exceptions to this rule include, *inter alia*, common trust funds defined in Code §584; trusts with a situs outside the U.S. or with any trust assets located outside the U.S.; qualified Subchapter S trusts, as described in Code §1361; and a trust which is wholly treated as owned by one grantor having a fiscal tax year.

A trustee who follows the first method does not have to file any return with the I.R.S.[9]

Decanting

The trustee is vested with various discretionary powers regarding trust arrangements. Such powers are of great importance in estate planning for both tax and nontax reasons. While they are not the focus of the discussion here, one form of trustee power, a so-called "Decanting" power, has attracted increased attention in recent years.

Decanting is the term generally used to describe "the distribution of [irrevocable] trust property to another trust pursuant to the trustee's discretionary authority to make distributions to, or for the benefit of, one or more beneficiaries [of the original trust]." Such distributions can be used to make various changes in the trust arrangements, including changes in trustee arrangements or other administrative aspects of the trust. They can also be used to change the tax status of the trust, such as changing a Grantor Trust into a Non-Grantor Trust or vice versa.

"Decanting can be used to make various changes in the trust arrangements, including changes in trustee arrangements or other administrative aspects of the trust."

The New York State Bar Association, the State Bar of Texas, and the American Institute of Certified Public Accountants have thus far submitted comments in response to the I.R.S. request in Notice 2011-101, urging, in particular that a Decanting which does not change beneficial interests in a material way should not be considered a distribution for income tax purposes.

Despite the moratorium announced in Rev. Proc. 2012-3 and Notice 2011-101, in Private Letter Ruling 201223012 (February 28, 2012), the I.R.S. ruled favorably on a ruling request submitted August 31, 2011. The request concerned the income tax, as well as the gift, estate, and generation-skipping tax, consequences, of the proposed division of an irrevocable trust after the settlor's death into separate trusts for the benefit of his two children and their issue. The aim was to better provide for their diverse economic interests and needs, notwithstanding the fact that the trust as originally drafted appeared to embody a "family pot" approach until the death of the last of the settlor's children. For income tax purposes, the ruling holds that the division would not be regarded as a distribution under Code §661, or as a taxable event to any of the trusts or their beneficiaries. The ruling was contingent on the entry of a state court order authorizing the division into two essentially separate shares.

Limits of Guidance by C.C.A. 201432022

For changes from Non-Grantor to Grantor Trust status, as outlined above, as well as Decanting, it is not clear how such a change should be treated from a filing perspective. C.C.A. 201432022 might be misleading in a way to suggest that filing of Form 1041 may be required, whereas under the applicable rules an exception from filing may apply (*e.g.*, Grantor Trust exception under Treas. Reg. §1.671-4(b)(2)(ii)(B)) or filing requirements are not clear (*e.g.*, Decanting).

SUMMARY

While providing clear guidance on filing requirements in the case of conversions from Domestic or from Foreign Trusts that fall under the Non-Grantor Trust rules and for Grantor Trusts that file Forms 1041, C.C.A. 201432022 leaves open questions with respect to certain conversion-related issues. In particular, it does not address cases where Grantor Trusts are not required to file Form 1041.

9 Treas. Reg. §1.671-4(b)(2)(ii)(B).