

# DOMESTIC TRUST – DOES YOURS SATISFY THE COURT TEST?

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## Tags

Court Test  
Domestic Trust

A trust is a relationship (generally a written agreement) created at the direction of an individual (the settlor), in which one or more persons (the trustees) hold the individual's property subject to certain duties to use and protect it for the benefit of others (the beneficiaries). In general, the term "trust" as used in the Internal Revenue Code ("Code") refers to an arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

Trusts can be characterized as non-grantor trusts, grantor trusts, simple trusts or complex trusts. Generally, if a trust is categorized as a grantor trust, its assets are treated as owned by the grantor (the settlor) for income tax purposes, resulting in the income generated by the trust being included in the grantor's taxable income; in contrast, a non-grantor trust is treated as a separate person from the grantor for income tax purposes. A simple trust is generally a trust that distributes its income on an annual basis; compared with a complex trust, which accumulates all or some of its income. Trusts can be domestic trusts or foreign trusts. The U.S. tax laws have special definitions for these concepts and this article discusses one of the tests for making a trust a U.S. domestic trust.

## A DOMESTIC TRUST

The status of a trust as foreign or domestic will affect the U.S. taxation and reporting requirements of the trust and its beneficiaries.

A trust is considered domestic if

- a U.S. court is able to exercise primary supervision over trust administration (the "court test"), and
- U.S. persons control all substantial trust decisions (the "control test").

All other trusts are considered Foreign Trusts.

### The Court Test

The court test includes special definitions:

- The term **court** includes any federal, state, or local court.
- The **U.S.** is used in a geographical sense. Thus, for purposes of the court test, the U.S. includes only the 50 States and the District of Columbia. Accordingly, a court within a territory or possession of the U.S. or within a foreign country is not a court within the U.S. for purposes of the court test.

- The term **is able to exercise** means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.
- The term **primary supervision** means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.<sup>1</sup>
- The term **trust administration** means all steps necessary to carry out the duties imposed by the terms of the trust and applicable law including maintaining the records of the trust, filing tax returns, managing and investing trust assets, defending the trust from suits by creditors, and determining the amount and timing of distribution.

If both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the court test.<sup>2</sup>

### **A Court Test Safe Harbor**

A trust satisfies the court test under a safe harbor if<sup>3</sup>

- the trust instrument does not direct that the trust be administered outside of the U.S.;
- the trust in fact is administered exclusively in the U.S.; and
- the trust is not subject to an automatic migration provision.

The trust is subject to automatic migration provision (a so called “flee clause”) if the trust document provides that a U.S. court’s attempt to assert jurisdiction or otherwise supervise the trust directly or indirectly would cause the trust to migrate from the U.S.

### **Examples**

Two examples in Treasury Regulations illustrate these concepts.<sup>4</sup>

In one example, a U.S. citizen, creates a trust for the equal benefit of A’s two children, both of whom are U.S. citizens. The trust instrument provides that DC, a domestic corporation, is to act as trustee of the trust and that the trust is to be administered in Country X, a foreign country. DC maintains a branch office in Country X with personnel authorized to act as trustees in Country X. The trust instrument provides that the law of State Y, a state within the U.S., is to govern the interpretation of the trust. Under the law of Country X, a court within Country X is able to exercise primary supervision over the administration of the trust. Pursuant to the trust instrument, the Country X court applies the law of State Y to the trust. Under the terms of the trust instrument the trust is administered in Country X. The example concludes that no court within the U.S. is able to exercise primary supervision over the administration

<sup>1</sup> A court may have primary supervision regarding the administration of the trust notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

<sup>2</sup> Treas. Reg. §301.7701-7(c)(4)(i)(D).

<sup>3</sup> Treas. Reg. §301.7701-7(c)(1).

<sup>4</sup> Treas. Reg. §301.7701-7(c)(5) Examples.

*“The fact that a trust agreement is governed by the laws of a State within the U.S. may not be sufficient to meet the court test. The determination weighs heavily on whether a U.S. court is able to render orders concerning the actions that govern the administration of the trust . . .”*

of the trust and therefore the trust fails to satisfy the court test and is a foreign trust. We can take from this that the choice of law as stated in the trust instrument, in this example State Y, will not be sufficient to make the trust a domestic trust where administration of the trust is to take place in Country X because it is assumed that a court within State Y is not able to exercise primary supervision over the administration of the trust as no administrative activities take place in State Y.

In another example, a U.S. citizen, creates a trust for A's own benefit and the benefit of A's spouse, B, also a U.S. citizen. The trust instrument provides that the trust is to be administered in State Y, a state within the U.S., by DC, a State Y corporation. The trust instrument also provides that in the event that a creditor sues the trustee in a U.S. court, the trust will automatically migrate from State Y to Country Z, a foreign country, so that no U.S. court will have jurisdiction over the trust. The example concludes that a court within the U.S. is not able to exercise primary supervision over the administration of the trust because the U.S. court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction.<sup>5</sup> Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

## SO, DOES YOURS SATISFY THE COURT TEST?

The fact that a trust agreement is governed by the laws of a State within the U.S. may not be sufficient to meet the court test. The determination weighs heavily on whether a U.S. court is able to render orders concerning the actions that govern the administration of the trust, *i.e.*, the maintaining of the records, the managing of the assets, the exercise of discretion with respect to distributions, etc. Clearly, when the safe harbor is met, the court test is satisfied. For that, all actions relating to the administration of the trust must be performed within the U.S. It is possible, however, for the court test to be met outside the safe harbor, although State law would have to be considered to assure primary (but not exclusive) supervision by a State court.

For those trusts where a U.S. third party institutional trustee or a U.S. individual trustee performs all administrative services in the U.S., there would be no question that a U.S. court would exercise primary supervision. It is possible in those cases that a non-U.S. court may also have jurisdiction, if, for example, there are trust assets situated outside the U.S., or the presence of a non-U.S. trustee outside the U.S.<sup>6</sup> Fortunately, U.S. court supervision, while primary, does not have to be exclusive.

But what of a privately held U.S. corporate trustee that performs all or some administrative functions abroad and therefore falls outside the safe harbor? And what of a U.S. citizen individual trustee residing outside the U.S. but who retains service providers in the U.S. to maintain the trust's books and records and to manage the trust's assets and investments?

<sup>5</sup> Not only is the safe harbor not met, but the court test is not met even before the flee clause is triggered.

<sup>6</sup> Which may, unrelatedly to the court test, affect the control test. A U.S. corporate trustee would be sufficient to satisfy the control test, even if its shareholders or directors are non-U.S. persons.

The Treasury Regulations' focus on administration reflects the most common definition of trust situs, as referred to in the Uniform Probate Code and Uniform Trust Code. The comment to UTC §108 (concerning designation of the principal place of administration) provides that

[L]ocating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust. It may also be important for other matters, such as payment of state income tax or determining the jurisdiction whose laws will govern the trust.

Further, the comment provides that

Because of the difficult and variable situations sometimes involved, the Uniform Trust Code does not attempt to further define principal place of administration. A trust's principal place of administration ordinarily will be the place where the trustee is located. Determining the principal place of administration becomes more difficult, however, when co[-]trustees are located in different states or when a single institutional trustee has trust operations in more than one state. In such cases, other factors may become relevant, including the place where the trust records are kept or trust assets held, or in the case of an institutional trustee, the place where the trust officer responsible for supervising the account is located.

Clearly State law must be reviewed if significant administrative activities are to occur outside the U.S. This could be relevant where the officers of a privately held trust company live outside the U.S. and where an individual trustee resides (or subsequently moves) outside the U.S. In that case, it would be advisable to ensure that sufficient administrative services take place within the U.S. to ensure that a U.S. court would have primary supervision.

## CONCLUSION

The characterization of a trust as a domestic or foreign trust is critical. While use of a U.S. trustee is necessary critical to achieve domestic status under the control test, it may not be enough if actual administration of the trust occurs outside the U.S. Practitioners representing foreign families should be mindful of this rule particularly if a private U.S. trust company or U.S. citizen individual trustee is part of the structure.