

PART I

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SERIES: INTERNATIONAL ESTATE PLANNING

**HOW DO I HAVE A "FOREIGN TRUST" IF I DON'T
LIVE OVERSEAS?**

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Our world today is more interconnected than ever before, and our clients are increasingly living, working, and investing across borders. That interconnectivity can create risks for trusts. If a trust is deemed a "foreign trust" for U.S. federal tax purposes, that can cause unintended and adverse tax consequences for both the grantor (creator) of the trust and its beneficiaries. It also may subject the trust to additional reporting requirements that carry hefty penalties for noncompliance. This foreign trust status can be triggered even if you, as the grantor of the trust, do not live overseas.

The Internal Revenue Code states simply that a foreign trust is any trust that is not a domestic trust. Thus, the default under the tax code is that a trust is *foreign* for federal income tax purposes, unless the trust qualifies as a domestic trust. For a trust to qualify as a domestic trust, the trust must satisfy both the "Court Test" and the "Control Test."

- 1. Court Test:** A court within the U.S. is able to exercise primary supervision over the administration of the trust.
- 2. Control Test:** One or more U.S. persons have the authority to control all substantial decisions of the trust.

For purposes of the Court Test, "primary supervision" is defined as "the authority to determine substantially all issues regarding the administration of the entire trust." The term "administration" means the carrying out of the duties imposed by the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions. Under a safe harbor provision in the Treasury Regulations, the Court Test is satisfied if the trust agreement does not direct the trust to be administered outside the United States, and it is, in fact, administered *exclusively* in the United States. For a trust created pursuant to the terms of a will probated within the United States, if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States, the trust meets the court test. For a trust other than a testamentary trust, the trust instrument will typically provide that the trust be administered in a certain state or district within the United States in which the creator of the trust or one or more of the trustees reside or are located. Thus, it is usually the case that the Court Test is met.

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The Control Test is more nuanced, and it is more often the trigger for foreign trust status. A "substantial decision" for purposes of the Control Test means a decision that a person is authorized or required to make under the terms of the trust agreement and applicable law and that is not ministerial in nature. If a non-U.S. person shares control over a "substantial decision," then you may risk triggering foreign trust status. This most often happens when one or more Trustees are non-U.S. persons, as further explained below. Some examples of substantial decisions include:

- Whether and when to distribute income or corpus;
- The amount of any distributions;
- The selection of beneficiaries;
- Whether to allocate trust receipts 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;
- Whether to appoint a successor trustee; and
- Investment decisions.

If any substantial decision requires a unanimous vote of the trustees and one of the trustees is a non-U.S. person, then the trust will fail the control test, i.e., the decision cannot be controlled by U.S. persons, and the trust will not qualify as a domestic trust. If, however, all substantial decisions require a majority vote of the trustees, and a majority of the trustees are U.S. persons, then the trust should satisfy the control test notwithstanding the presence of a non-U.S. trustee. For example, if a trust has three trustees, two of whom are U.S. persons and one of whom is a Canadian, then a majority voting requirement in the trust agreement should be sufficient to qualify the trust as a domestic trust – the U.S. trustees have the authority to control. On the other hand, if a trust has two acting trustees with co-equal powers, and one trustee is a non-U.S. person, then the trust likely will not qualify as a domestic trust.

All persons who have authority to make such decisions, whether acting in a fiduciary capacity or not, can be considered. While the trustees are typically the individuals with much of the decision-making authority, certain decisions are often granted to another person named under the trust instrument, who may not be a trustee. For example, the

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decision to remove, add or replace a trustee is frequently made by a trust "protector," and investment authority is sometimes given to an investment director or adviser named in the trust agreement.^[1] For purposes of qualifying a trust as a domestic trust under the Control Test, all of these roles should be considered.

Unless a trust is specifically drafted to prohibit non-U.S. persons from exercising control, it is possible for a domestic trust to inadvertently become a foreign trust upon the succession of a trustee or trust protector, such as where a U.S. trustee resigns, and a non-U.S. person succeeds to the role. Although the Treasury Regulations provide for a 12-month period within which to cure an unintentional conversion to a foreign trust, clients should keep in regular communication with their legal advisors when a change of trustee or other individual having authority over trust decisions could cause a trust to fail the Control Test.

Please contact a Wiggin and Dana attorney if you have questions or concerns about triggering foreign trust status, or to discuss other aspects of international estate planning. We would be happy to speak with you.