

# **Notice of Proposed Rulemaking and Notice of Public Hearing**

## **Classification of Certain Pension and Employee Benefit Trusts, and Other Trusts**

**REG-108553-00**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed amendments to the regulations defining a domestic or foreign trust for federal tax purposes. The proposed regu-

lations will affect certain specified employee benefit trusts and investment trusts. The proposed amendments provide that these employee benefit trusts and investment trusts are deemed to satisfy the control test for domestic trust treatment if United States trustees control all of the substantial decisions of the trust made by the trustees of the trust. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written or electronic comments must be received by January 10, 2001. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for January 31, 2001, at 10 a.m. must be submitted by January 10, 2001.

**ADDRESSES:** Send submissions to: CC:M&SP:RU (REG-108553-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-108553-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/tax\\_regs/reglist.html](http://www.irs.ustreas.gov/tax_regs/reglist.html). The public hearing will be held in the Internal Revenue Service Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, James A. Quinn, (202) 622-3060; concerning submissions and the hearing, Guy R. Traynor, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

Section 401(a) requires a trust forming part of a pension, profit-sharing, or stock bonus plan (qualified plan trust) to be created or organized in the United States in order to be a qualified trust. Similarly, section 408(a) requires an individual retirement account trust (IRA trust), which also includes a trust for a Simple IRA described in section 408(p) and a trust for a

Roth IRA described in section 408A, to be created or organized in the United States. Section 1.401-1(a)(3)(i) further provides that a trust will not constitute a qualified trust under section 401(a) unless the trust is maintained at all times as a domestic trust in the United States. Under §1.408-2(b), a similar requirement applies to an IRA trust.

Prior to the enactment of the Small Business Job Protection Act (SBJPA), Public Law 104-188 (110 Stat. 1755) (August 20, 1996), the status of a qualified plan trust as a domestic trust generally turned on a facts and circumstances determination that the trust was a resident trust and was subject to the continuous jurisdiction of the United States. See, for example, Rev. Rul. 70-242 (1970-1 C.B. 89) regarding the determination of domestic trust status for purposes of section 401(a).

The SBJPA and the Taxpayer Relief Act of 1997 (TRA 97), Public Law 105-34 (111 Stat. 788) (August 5, 1997), amended section 7701(a)(30) to provide objective criteria for determining whether a trust is a domestic trust. New section 7701(a)(30)(E) provides that a trust will be treated as a domestic trust if: (1) a court within the United States is able to exercise primary supervision over the administration of the trust (court test), and (2) one or more United States persons have the authority to control all substantial decisions of the trust (control test). These changes are generally effective for taxable years beginning after December 31, 1996.

Section 301.7701-7, published in the **Federal Register** on February 2, 1999 (64 FR 4967), provides guidance under section 7701(a)(30)(E) in determining whether a trust is treated as a United States person and therefore as a domestic trust for federal tax purposes. The regulations are generally effective for taxable years ending after February 2, 1999, but may be applied by taxpayers for taxable years beginning after December 31, 1996. In addition, section 1907(a)(3) of the SBJPA, as amended by the TRA 97, generally provides that, to the extent prescribed in regulations, a trust that was in existence on August 20, 1996, and that was treated as a United States person on August 19, 1996, may elect to continue to be treated as a United States person. Sec-

tion 301.7701-7(f) provides rules governing this election to continue to be treated as a United States person.

Section 301.7701-7(d) provides guidance on the application of the control test, including defining United States persons, substantial decisions, and control. Generally, for purposes of the control test, all persons with any power over substantial decisions of the trust, whether acting in a fiduciary capacity or not, must be counted for purposes of the control test.

However, §301.7701-7(d)(1)(iv) provides a special rule for certain employee benefit trusts listed therein. These trusts are required to be created or organized in the United States and are subject to other detailed requirements for qualification under the Internal Revenue Code (Code). Therefore, §301.7701-7(d)(1)(iv) provides that these trusts are deemed to satisfy the control test, provided that United States fiduciaries control all of the substantial decisions of the trust that are made by the trustees or fiduciaries. Section 301.7701-7(d)(1)(iv) authorizes the Commissioner to designate additional categories of trusts subject to the special rule in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin.

#### Explanation

The IRS and the Treasury Department have become aware of two additional categories of trusts that should qualify for the special control test rule in §301.7701-7(d)(1)(iv).

The first category is group trusts consisting of qualified plan trusts and IRA trusts, as described in Rev. Rul. 81-100 (1981-1 C.B. 326). If the requirements set forth in Rev. Rul. 81-100 are met, a group trust is itself exempt from tax, and the tax-exempt status of the participating trusts is not affected by the pooling of their funds in the group trust. One of the requirements is that the group trust must be created or organized in the United States and must be maintained at all times as a domestic trust in the United States. 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 §301.7701-7(d)(1)(iv). Therefore, the proposed regulations add group trusts de-

scribed in Rev. Rul. 81-100 to the categories of trusts that may use the special control test rule.

The second category is certain investment trusts that are classified as trusts under §301.7701-4(c)(1). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets in the trust, is classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders. In addition, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, is classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose. These trusts are treated as owned by the investors under the grantor trust rules of subpart E, part I, subchapter J, chapter 1 of the Code.

The proposed regulations add investment trusts classified as trusts under §301.7701-4(c)(1) to the categories of trusts that may use the special control test rule, provided the investment trusts meet the conditions described in §301.7701-7(d)(1)(iv)(I). 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 conditions set forth in the proposed regulations are intended to ensure that all trustees are United States persons including at least one institutional United States trustee, the sponsors (persons who exchange investment assets for beneficial interests with a view to selling the beneficial interests) are United States persons, and the beneficial interests are widely offered for sale primarily in the United States to United States persons. An investment trust that satisfies these conditions is 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.

In addition, the IRS and the Treasury Department have become aware of concerns expressed by taxpayers in applying the special rule of §301.7701-7(d)(1)(iv)

with respect to determining whether a person is or is not a fiduciary for purposes of the control test. For example, under section 3(14)(A) of the Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93-406 (88 Stat. 829) (September 2, 1974), a variety of persons in addition to the trustee(s) is considered fiduciaries with respect to an employee benefit trust. In contrast, under ordinary trust principles the fiduciary of a trust is generally considered to be the trustee holding legal title to the trust assets on behalf of those having a beneficial interest therein. Section 301.7701-6(b). Therefore, these regulations propose to amend §301.7701-7(d)(1)(iv) relating to the application of the control test of section 7701(a)(30)(E) to clarify that employee benefit trusts and certain investment trusts identified in the regulations are deemed to satisfy the control test if United States trustees control all of the substantial decisions of the trust made by the trustees of the trust.

Taxpayers concerned with maintaining domestic trust status should also note that, in appropriate cases, it may still be possible to elect pursuant to §301.7701-7(f) to treat a trust existing on August 19, 1996, as a United States person.

#### *Application to Certain Pension Trusts Created or Organized in Puerto Rico*

Section 1022(i)(1) of ERISA provides for tax exemption for certain trusts created or organized in Puerto Rico that form part of a pension, profit-sharing, or stock bonus plan. Section 1022(i)(2) and §1.401(a)-50 generally provide that the administrator of such a trust may elect to have the trust treated as a trust created or organized in the United States for purposes of section 401(a). In light of the changes made to section 7701(a)(30) in the SBJPA and the TRA 97, and the ensuing regulations, some taxpayers have expressed concerns regarding the continuing application of sections 1022(i)(1) and (2) and §1.401-50 to a pension trust created or organized in Puerto Rico that is not a domestic trust within the meaning of section 7701(a)(30). Because the application of these provisions is not restricted to trusts that are domestic trusts within the meaning of section 7701(a)(30), the 1996 and 1997 amendments to section 7701(a)(30) and the ensu-

ing regulations do not affect the application of these provisions.

#### **Proposed Effective Date**

The amendments to the regulations are proposed to be applicable to trusts for taxable years ending on or after the date on which these regulations are published as final regulations in the **Federal Register**. 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, and for electing trusts under section 1907(a)(3)(B) of the SBJPA for taxable years ending after August 20, 1996. In addition, for taxable years beginning after December 31, 1996, and taxable years ending before these regulations are finalized, or for electing trusts under section 1907(a)(3)(B) of the SBJPA for taxable years ending after August 20, 1996, and before these regulations are finalized, the status of a trust as a qualified plan trust under section 401(a), an IRA trust under section 408(a), or any other employee benefit trust described in §301.7701-7(d)(1)(iv) of these proposed regulations will not be challenged by the IRS based on a failure of the trust to satisfy the control test of section 7701(a)(30)(E)(ii) and, therefore, a failure to be maintained at all times as a domestic trust in the United States, if the trust satisfies the control test safe harbor set forth in §301.7701-7(d)(1)(iv) of these proposed regulations or §301.7701-7(d)(1)(iv) of the final regulations published in the **Federal Register** on February 2, 1999.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to

the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Comments and Public Hearing.

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 31, 2001, at 10 a.m. in the Internal Revenue Service Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by January 10, 2001, and submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by January 10, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

## Drafting Information

The principal author of these regulations is James A. Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

## PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 301.7701–7 is amended as follows:

1. Paragraph (d)(1)(iv) introductory text is revised.

2. Paragraph (d)(1)(iv)(H) is redesignated as paragraph (d)(1)(iv)(J).

3. New paragraphs (d)(1)(iv)(H) and (I) are added.

4. Paragraph (d)(1)(v) *Example 1* is revised and *Example 5* is added.

5. The first sentence of paragraph (e)(1) is revised.

6. Paragraph (e)(3) is added.

The revisions and additions read as follows:

### *§301.7701–7 Trusts—domestic and foreign.*

\* \* \* \*

(d) \* \* \* (1) \* \* \*

(iv) *Safe harbor for certain employee benefit trusts and investment trusts.* Notwithstanding the provisions of this paragraph (d), the trusts listed in this paragraph (d)(1)(iv) are deemed to satisfy the control test set forth in paragraph (a)(1)(ii) of this section, provided that United States trustees control all of the substantial decisions made by the trustees of the trust—

\* \* \* \*

(H) A group trust described in Rev. Rul. 81–100 (1981–1 C.B. 326) (See §601.601(d)(2) of this chapter);

(I) An investment trust classified as a trust under §301.7701–4(c), provided that the following conditions are satisfied—

(1) All trustees are United States persons and at least one of the trustees is a bank, as defined in section 581, or a United States Government-owned agency or United States Government-sponsored enterprise;

(2) All sponsors (persons who exchange investment assets for beneficial interests with a view to selling the beneficial interests) are United States persons; and

(3) The beneficial interests are widely offered for sale primarily in the United States to United States persons;

\* \* \* \*

(v) \* \* \*

*Example 1.* Trust is a testamentary trust with three fiduciaries, A, B, and C. A and B are United States citizens and C is a nonresident alien. No persons except the fiduciaries have authority to make any decisions of the trust. The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. The control test is not satisfied because United States persons do not control all the substantial decisions of the trust. No substantial decisions can be made without C's agreement.

\* \* \* \*

*Example 5.* X, a foreign corporation, conducts business in the United States through various branch operations. X has United States employees and has established a trust as part of a qualified employee benefit plan under section 401(a) for these employees. The trust is established under the laws of State A, and the trustee of the trust is B, a United States bank governed by the laws of State A. B holds legal title to the trust assets for the benefit of the trust beneficiaries. A plan committee makes decisions with respect to the plan and the trust. The plan committee can direct B's actions with regard to those decisions and under the governing documents B is not liable for those decisions. Members of the plan committee consist of United States persons and nonresident aliens, but nonresident aliens make up a majority of the plan committee. Decisions of the plan committee are made by majority vote. In addition, X retains the power to terminate the trust and to replace the United States trustee or to appoint additional trustees. This trust is deemed to satisfy the control test under paragraph (d)(1)(iv) of this section because B, a United States person, is the trust's only trustee. Any powers held by the plan committee or X are not considered under the safe harbor of paragraph (d)(1)(iv) of this section. In the event that X appoints additional trustees including foreign trustees, any powers held by such trustees must be considered in determining whether United States trustees control all substantial decisions made by the trustees of the trust.

\* \* \* \*

(e) *Effective date—(1) General rule.* Except for the election to remain a domestic trust provided in paragraph (f) of this section and except as provided in paragraph (e)(3) of this section, this section is applicable to taxable years ending after February 2, 1999.

\* \* \* \*

(3) *Effective date of safe harbor for certain employee benefit trusts and investment trusts.* Paragraphs (d)(1)(iv) and (v) *Examples 1* and *5* of this section apply to trusts for taxable years ending on or after the date of publication of final regulations in the **Federal Register**. Paragraphs (d)(1)(iv) and (v) *Examples 1* and *5* of this section may be relied on by trusts for taxable years beginning after December 31, 1996, and also may be relied on by

trusts whose trustees have elected to apply sections 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996, under section 1907(a)(3)(B) of the SBJP Act.

\* \* \* \* \*

David A. Mader,  
*Acting Commissioner  
of Internal Revenue.*

(Filed by the Office of the Federal Register on October 10, 2000, 3:31 p.m., and published in the issue of the Federal Register for October 12, 2000, 65 F.R. 60821)