

Part III. Administrative, Procedural, and Miscellaneous

Treatment of a Trust as Domestic or Foreign—Changes Made by the Small Business Job Protection Act

Notice 96-65

This notice provides guidance with respect to certain provisions of the Small Business Job Protection Act of 1996 (the “Act”), Public Law 104-188, 110 Stat. 1755 (August 20, 1996), dealing with the status of a trust as domestic or foreign under sections 7701(a)(30) and 7701(a)(31) of the Internal Revenue Code (the “Code”). The first section of this notice grants trusts that meet the conditions specified in this notice additional time to comply with the new domestic trust criteria contained in the Act and allows such trusts to continue to file as a domestic trusts during this period. The second section of this notice addresses the time and manner for making the election provided by the Act to apply the new trust criteria retroactively. The third section of this notice provides guidance regarding the application of sections 1491 through 1494 of the Code if the status of a trust changes from domestic to foreign.

BACKGROUND

Prior to the Act, the status of a trust as domestic or foreign turned upon the subjective determination of whether the trust was more comparable to a resident or a nonresident alien individual. See Rev. Rul. 60-181, 1960-1 C.B. 257, citing *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943). Section 1907(a) of the Act amended sections 7701(a)(30) and (31) of the Code to provide more objective criteria for determining the status of a trust. New section 7701(a)(30) provides that a trust will be treated as a domestic trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. New section 7701(a)(31) provides that a foreign trust is any trust that is not a domestic trust.

Section 1491 imposes a 35 percent excise tax on a transfer of property by a U.S. person, including a domestic trust, to a foreign trust. In general, the excise tax is imposed on the excess of the fair market value of the property transferred

over the adjusted basis of such property plus any gain recognized on the transfer by the U.S. person.

If a domestic trust becomes a foreign trust, such trust shall be treated for purposes of section 1491 as having transferred, upon becoming a foreign trust, all of its assets to a foreign trust. Act section 1907(b), amending section 1491. However, to the extent that a grantor or another person is treated as the owner of all or a portion of the trust under sections 673 through 679 when such trust becomes a foreign trust, the portion of the trust owned by such person is not taken into account in determining the assets treated as transferred to the foreign trust for purposes of section 1491. See, e.g., Rev. Rul. 87-61, 1987-2 C.B. 219.

New sections 7701(a)(30) and (31) apply in determining the status of a trust for taxable years beginning after December 31, 1996. A trustee of a trust may, however, elect to have the new criteria apply to the first taxable year of the trust ending after August 20, 1996 (the date of enactment of the Act). Act section 1907(a)(3).

ADDITIONAL TIME TO COMPLY WITH NEW DOMESTIC TRUST CRITERIA

In the first taxable year that new section 7701(a)(30) applies, it is possible for a trust treated as a domestic trust under prior law to become a foreign trust solely by operation of the new law, notwithstanding that the trust may prefer to remain a domestic trust for U.S. tax purposes. In that event, the domestic trust may be subject to the 35 percent excise tax on any built-in gain in its assets as of the date of its change in status.

Certain existing domestic trusts that desire to remain domestic trusts may have difficulty meeting the new domestic trust criteria in section 7701(a)(30) prior to the first taxable year beginning after December 31, 1996. Treasury and the Service believe that these trusts should have a reasonable amount of time to comply with the new domestic trust criteria. Accordingly, a domestic trust in existence on August 20, 1996 (“existing trust”), may continue to file tax returns as a domestic trust for taxable years of the trust beginning after December 31, 1996, if the trust satisfies the conditions of this notice. This relief

is not available to a trust if an election has been made pursuant to section 1907(a)(3)(B) of the Act to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996.

An existing domestic trust must satisfy the following conditions to qualify for the relief provided by this section of the notice: (1) the trustee must initiate modification of the trust to conform with the domestic trust criteria by the due date (including extensions) for filing the trust’s income tax return for its first taxable year beginning after December 31, 1996; (2) the trustee must complete the modification within two years of that date (“two-year period”); and (3) the trustee must attach a statement to the trust’s income tax return as described below. If an existing domestic trust meets these conditions, it may continue to file as a domestic trust for taxable years of the trust beginning after December 31, 1996. For purposes of this notice, “modification” includes any action taken (judicial or nonjudicial) to reform, amend, modify, or alter the trust that is effective under local law.

The statement referred to above must be entitled “Election to Rely on Notice 96-65 to File as a Domestic Trust,” and must be attached to the trust’s income tax return for each taxable year that this notice is relied on to file as a domestic trust. The statement must be signed under penalties of perjury by the trustee and contain the following information:

(1) A statement that the trust is relying on this notice to file as a domestic trust for the taxable year;

(2) A statement that the trustee filed original income tax returns treating the trust as a domestic trust for each taxable year of the trust beginning after 1994, and will continue to file as a domestic trust while actions are being taken to meet the domestic trust criteria;

(3) The date on which actions to modify the trust to meet the domestic trust criteria were initiated and a brief description of both completed and forthcoming actions necessary to meet the domestic trust criteria;

(4) The name, taxpayer identification number, and address of any U.S. person who, but for the relief provided in this notice, would be treated as the owner of all or a portion of the trust under section 679 for any taxable year of the trust beginning after December 31, 1996; and

(5) A statement that, if the trust does not meet the domestic trust criteria in section 7701(a)(30) by the end of the two-year period, the trustee will file all of the trust's applicable returns (whether original or amended) for taxable years of the trust beginning after December 31, 1996, treating the trust as a foreign trust.

If the trust satisfies the trust criteria in section 7701(a)(30) by the end of the two-year period, the trust will be treated as a domestic trust during this period for all purposes of the Code. In the case of an existing domestic trust that fails to meet the conditions set forth in this notice to continue to file as a domestic trust, such trust will be treated as a foreign trust for all taxable years of the trust beginning after December 31, 1996, for all purposes of the Code. In that event, any U.S. person who is treated as owning all or a portion of the trust for any taxable year of the trust beginning after December 31, 1996, and any beneficiary whose tax liability was affected by the change in the trust's status must file amended returns in order to correctly report their income tax liability for any taxable year that the trust relied on this notice to file as a domestic trust.

If reasonable actions have been taken to meet the domestic trust criteria, but due to circumstances beyond the trustee's control the trust is unable to meet such criteria by the date set forth in this notice, the trustee may provide a written statement to the District Director having jurisdiction over the trust's return setting forth the reasons for failing to meet the domestic trust criteria in a timely manner. If the District Director determines that the failure was due to reasonable cause, the District Director may grant the trust an extension of time to meet such criteria. Whether an extension of time is granted shall be in the sole discretion of the District Director and, if granted, may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the trust does not obtain an extension from the District Director before the end of the two-year period, then the trustee must treat the trust as a foreign trust for all taxable years of the trust beginning after December 31, 1996.

The following example illustrates the relief provided by this section of the notice. Assume a U.S. court has primary supervision over an existing domestic

trust with a single foreign trustee. The trust, a calendar year taxpayer, is not treated as owned by the grantor or another person under sections 673 through 679. On April 1, 1998, the foreign trustee tenders his letter of resignation to take effect upon appointment of a new U.S. trustee. The trustee attaches the statement described in this notice to the trust's 1997 tax return. A new U.S. trustee is appointed on July 30, 1998, and the trustee attaches the required statement to the trust's 1998 tax return.

The trust may continue to file as a domestic trust for the 1997 and 1998 taxable years because (1) the trustee initiated modification of the trust by the due date for filing the trust's income tax return for its first taxable year beginning after December 31, 1996; (2) the modification was completed within two years of the due date for filing the trust's 1997 return; and (3) the trustee attached the required statement to the trust's 1997 and 1998 income tax returns.

If, however, a new U.S. trustee had not been appointed by the end of the two-year period, and an extension of time had not been granted by the District Director, the trust would have been treated as a foreign trust for all taxable years beginning after December 31, 1996. For purposes of section 1491 such trust would have been treated as having transferred all of its assets to a foreign trust upon becoming a foreign trust on January 1, 1997.

ELECTION TO APPLY NEW TRUST CRITERIA RETROACTIVELY

New sections 7701(a)(30) and (31) apply to determine whether a trust is domestic or foreign for taxable years beginning after December 31, 1996. However, under section 1907(a)(3)(B) of the Act, a trustee of a trust may elect to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996 ("the election year"). This section of the notice announces the time and manner for making the election.

If an election is made to apply new sections 7701(a)(30) and (31) to the trust's first taxable year ending after August 20, 1996, the new trust criteria must be applied for the entire election year. Thus, for example, if a domestic trust with the calendar year as its taxable year has a single foreign trustee, and that trustee elects to apply new

sections 7701(a)(30) and (31) to the trust's 1996 taxable year, then the trust will be treated as a foreign trust beginning on January 1, 1996.

To make the election, the trustee must attach a statement entitled "Election Under Section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996 to Apply New Trust Criteria Retroactively," to the trust's income tax return for its first taxable year ending after August 20, 1996. The statement must be signed under penalties of perjury by the trustee and contain the following information:

(1) A statement that the trust is relying on this notice to apply the new trust criteria for its first taxable year ending after August 20, 1996;

(2) A declaration stating whether the trustee has filed an original U.S. income tax return treating the trust as a domestic trust for any of the three immediately preceding taxable years; and

(3) A declaration stating whether, during the election year, there has been a change in trust status.

If a trust changes status from domestic to foreign as a result of this election, the trustee must, as a condition of making the election, attach a statement agreeing to treat the change in trust status as a transfer of the trust's assets to a foreign trust for purposes of section 1491, except to the extent the grantor or another person is treated as the owner of the trust under sections 673 through 679 when such trust becomes a foreign trust.

APPLICATION OF SECTIONS 1491 THROUGH 1494

If the status of a trust changes from domestic to foreign as a result of the new law, whether or not by reason of an election to apply the new trust criteria retroactively, for purposes of section 1491 the trust will be treated as having made a transfer of all of its assets to a foreign trust upon becoming a foreign trust, except to the extent a grantor or another person is treated as the owner of the trust under sections 673 through 679 when such trust becomes a foreign trust. Act section 1907(b); *See also* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 338 (1996). In the case of an existing domestic trust that fails to meet the conditions set forth earlier in this notice to continue to file as a domestic trust, then to the extent there is a transfer of assets to the foreign trust for purposes of section 1491, such transfer will occur upon the trust becoming a

foreign trust at the beginning of the first taxable year beginning after December 31, 1996.

Under section 1494(a), the excise tax imposed by section 1491 is due and payable at the time of the transfer. Treasury and the Service expect to issue regulations under section 1494 that will provide that any excise tax due on a transfer of assets to a foreign trust as a result of a change in trust status may be paid by attaching Form 926, and any applicable excise tax, to the trust's income tax return for the taxable year in which the transfer occurs. If the excise tax is not paid until the trust's income tax return for the year is filed, interest must be paid on the amount of excise tax due at the rates determined under section 6621, with respect to the period between the date on which the transfer occurred and the date on which the excise tax is actually paid. Until regulations are issued, the guidance provided by this section of the notice may be relied on by taxpayers. For penalties applicable for failure to report a transfer of property described in section 1491, see Act section 1902, adding section 1494(c) and Notice 96-60, 1996-49 I.R.B. 7.

In the case of an existing domestic trust that has relied in good faith on the first section of this notice to continue to file as a domestic trust, but fails to meet the criteria in section 7701(a)(30) by the end of the two-year period, the trustee must make a return on Form 926 no later than thirty day after the end of the two-year period to report a section 1491 transfer that occurs on the change in the trust's status, and to pay any excise tax and interest due. Form 926 may be attached to an amended return filed by the trustee for the first taxable year of the trust ending after December 31, 1996. If Form 926 is filed no later than thirty days after the end of the two-year period, no penalties will be imposed under section 1494(c).

Under section 1492, the excise tax imposed by section 1491 shall not apply to: transfers to certain exempt organizations (section 1492(1)); transfers described in section 367 (section 1492(2)(A)); transfers with respect to which an election has been made to apply principles similar to the principles of section 367 (section 1492(2)(B)); or transfers with respect to which an election has been made under section 1057 (section 1492(3)). A transfer to a foreign trust that occurs as a result of a change in trust status from domestic to foreign

may be nontaxable under sections 1492(1) and (3). Such a transfer cannot be nontaxable under section 1492(2)(A) because the transfers described in section 367 are limited to transfers to foreign corporations.

Treasury and the Service are studying whether it is appropriate to allow a domestic trust that becomes a foreign trust to elect to apply principles similar to the principles of section 367 under section 1492(2)(B) and, if so, how such principles should be applied. Until further guidance is provided, a domestic trust that becomes a foreign trust may not avoid the section 1491 excise tax by electing principles similar to the principles of section 367, unless the trust obtains a private letter ruling with respect to the application of the principles of section 367 to its particular facts.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1506.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in this notice are in the sections headed *Additional Time to Comply with New Domestic Trust Criteria* and *Election to Apply New Trust Criteria Retroactively*. This information is required by the IRS to assure compliance with the new provisions of the Small Business Job Protection Act of 1996. The likely respondents are individuals, business or other for-profit institutions, and not-for-profit institutions.

The estimated total annual reporting burden is 550 hours.

The estimated average annual burden per respondent is 27 minutes. The estimated number of respondents is 1,200.

The estimated annual frequency of responses is annually.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this notice is Wendy Stanley of the Office of Associate Chief Counsel (International). For further information regarding sections 1491 through 1494 contact Ms. Stanley on (202) 622-3860 (not a toll-free call). For further information regarding sections 7701(a)(30) and (31) contact James A. Quinn on (202) 622-3060 (not a toll-free call).

26 CFR 1.127-2: Educational Assistance Programs.

Definitions Relating to Application of Exclusion Under Section 127 of the Internal Revenue Code

Notice 96-68

This notice provides guidance regarding certain definitions affecting the proper tax treatment of educational assistance received by employees under § 127 of the Internal Revenue Code as amended by the Small Business Job Protection Act of 1996, Pub. L. 104-188 (the "Act").

Section 1202 of the Act restores the exclusion from gross income for up to \$5,250 of educational assistance provided under an educational assistance program described in § 127, effective for an employee's first taxable year beginning after December 31, 1994. The Act amends the definition of "educational assistance" to provide that, for graduate level courses, the exclusion does not apply to expenses relating to courses "beginning after June 30, 1996." For this purpose, a "graduate level course" will be treated as meaning any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree. Section 127(c)(1). This is the same definition set forth in Notice 89-33, 1989-1 C.B. 674, with respect to amendments made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, relating to graduate level courses.

The amendment of the term "educational assistance" to exclude graduate level courses applies to courses beginning after June 30, 1996. Similarly, the § 127 exclusion only applies with respect to "courses beginning" before a specified date in 1997. For purposes of