Estate & Succession Planning Corner

New Developments in the Law of Foreign Grantor, Grantor Trusts

By Lawrence I. Richman[*]

With the passage of the Tax Cut and Jobs Act of 2017, the United States has sought to become a more attractive tax destination for both U.S. and foreign persons. Indeed, one of the more surprising developments in the law is that nonresident aliens may become shareholders of Subchapter S corporations, if they do so as a beneficiary of an Electing Small Business Trust (an "ESBT") under Code Sec. 1361(e). The bar for creating an ESBT is about as low as it gets in the trust world: anyone, including a nonresident alien, can create a wholly revocable trust, cause that trust to be a shareholder of a U.S. corporation and then have that corporation and its shareholders make "S" and ESBT elections, respectively.

Presumably, one of the reasons that the bar was set so low was the fact that historically ESBTs were taxed at the highest individual/trust rates of income tax. That paradigm has shifted with the introduction of Code Sec. 199A and the concept of Qualified Business Income ("QBI"). Now shareholders of "S" corporations, including ESBTs, can deduct up to 20% of their QBI and, given how easy it is to create ESBTs, it is possible to imagine a string of ESBTs in sufficient numbers so that the income of each does not exceed the $157,500 threshold thus allowing for the 20% deduction without further adjustment.

Like so many aspects of the rules that apply to nonresident aliens, the rules that cause a trust to be a grantor trust with respect to a nonresident alien have undergone changes over time leaving some trusts with foreign grantors seemingly ineligible to be treated as a grantor trust. A recent private letter ruling[1] provides an insight to an approach that can solve nonstatutorily compliant foreign grantor, grantor trusts.

A person who creates a trust and retains certain rights or powers over the trust generally may be treated as the owner of the trust's assets pursuant to the "grantor trust rules" of Subpart E of the Code. For example, Code Sec. 677 provides that the "grantor shall be treated as the owner of any portion of a trust, … whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be … distributed to the grantor … [or] held or accumulated for future distribution to the grantor …." Code Sec. 672(a) defines an adverse party as a person who has "a substantial

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beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the [grantor's] power which he possesses respecting the trust."

When a trust has a foreign grantor, these rules have been modified pursuant to Code Sec. 672(f), originally adopted by Congress as part of the Revenue Reconciliation Act of 1990.[2] The currently applicable portions of Code Sec. 672(f)[3] provide that:

> (1) IN GENERAL. Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

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> (2) EXCEPTIONS.
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> (A) CERTAIN REVOCABLE AND IRREVOCABLE TRUSTS.
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> (i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor, or
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> (ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

Section 1904(d)(2) of the Small Business Job Protection Act of 1996 contained a "Statutory Exception" from the new rules for certain existing trusts:

> (2) EXCEPTION FOR CERTAIN TRUSTS.—The amendments made by this section shall not apply to any trust—
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> (A) which is treated as owned by the grantor under section 676 or 677 (other than subsection (a)(3) thereof) of the Internal Revenue Code of 1986; and
>
> (B) which is in existence on September 19, 1995.

The preceding sentence shall not apply to the portion of any trust attributable to any transfer to such trust after September 19, 1995.

On August 5, 1999, the Treasury Department adopted final regulations that effectively expanded the scope of the statute beyond its specific language to cover trusts otherwise within the Statutory Exception.[4] Reg. §1.672(f)-3(b)(3) provides that "the general rule of Section 1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) *on September 19, 1995, as long as the trust would continue to be so treated thereafter*. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995." (Emphasis added.) This "Regulatory Rule" under the final regulations applies to taxable years of a trust beginning after August 10, 1999.[5]

The Regulatory Rule imposes significant restrictions that would not otherwise be required by the Statutory Exception. Congress did not include in the statute itself the requirement that these pre-existing trusts be "treated as owned" on September 19, 1995, and continuously thereafter, but rather treated any additional contributions to such trusts separately by disallowing the exception for "the portion of any trust attributable to any transfer to such trust after September 19, 1995." Such a sentence would have been meaningless if Congress had intended to allow the exception only for "the portion of a trust that was continuously deemed owned by the grantor on September 19, 1995." Moreover, Congress preserved the earlier effective date concept that such rules should apply only to trusts created after the effective date of the statute's enactment and any additions to an existing trust. The only substantive change between the two statutory effective date provisions was to limit the availability of the grantor trust rules to Code Secs. 676 and 677 (other than subsection (a)(3)). Since grantor trust status may change from year to year depending, among other things, on the beneficial interests in the trust, Congress should have been aware that, pursuant to these two sections of the Code, the status of a grandfathered grantor trust could

change and that nongrantor trusts could later be treated as grantor trusts with respect to a foreign person. Simply put, Congress could have added language to specifically limit the Statutory Exception or implement the Regulatory Rule, but failed to do so.

Instead of attacking the IRS's rulemaking, the trust's grantor in LTR 201807001 sought reformation of the trust. The trust in LTR 201807001 permitted discretionary distributions to beneficiaries outside the permitted scope of Code Sec. 672(f) as the statute now reads and as retroactively applied by Treasury by regulation. In pursuing reformation and accepting the retroactive rulemaking of Treasury, the Trustee took advantage of authority provided in the trust agreement which allowed an independent trustee "to reform by a writing made and filed with the records of such Trust … any of the provisions of the Trust Agreement … to the end and purpose that burdensome tax consequences may, consistent with the purposes of such Trust … be eliminated or minimized."[6]

Using this decanting power, the grantor filed an action to reform the trust to comply with the terms of Code Sec. 672(f)(2)(A)(ii). Crucially, not only the grantor but also the attorney testified to the intention that the trust be a foreign grantor, grantor trust. This evidence, coupled with the court's recognition that there had been a retroactive change in tax rules governing the determination of foreign grantor, grantor trust status, allowed the court to conclude that the trust as initially written reflected mistakes of both fact and law.

The IRS found the court's determination met the *Bosch*[7] standard that the reformation involve *bona fide* issues and be consistent with the law that would be applied by the highest court of the jurisdiction. While the IRS accepted the reformation as achieving the desired tax results *nunc pro tunc*, taxpayers should not necessarily see it as a too ready path to taxpayer success. In issuing its ruling, the IRS highlighted the "unique circumstances"[8] presented by the grantor. Clearly, the IRS has no desire that taxpayers use trust reformation as an end run around the retroactive application of tax law. Notwithstanding the warning, the use of trust reformation in appropriate circumstances as a way to achieve foreign grantor, grantor trust status is important at a time when foreign grantor, grantor trusts present new tax planning possibilities in ESBT and "S" corporation planning.

ENDNOTES

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- [1] LTR 201807001 released February 16, 2018.
- [2] Act Sec. 11343(a) of the Revenue Reconciliation Act of 1990 (P.L. 101-508). This original provision has been re-designated as Code Sec. 672(f)(5) and is effective for any trust created after November 5, 1990, or any portion of a trust created on or before such date which is attributable to amounts contributed to the trust after such date.
- [3] Enacted as part of the Act Sec. 1904(a)(1) of the Small Business Job Protection Act of 1996 (P.L. 104-188).
- [4] T.D. 8831, IRB 1999-34, 264.
- [5] Reg. §1.672(f)-3(e).
- [6] LTR 201807001 (Nov. 13, 2017).
- [7] *H.J. Bosch Est.*, SCt, 67-2 USTC ¶12,472, 387 US 456.
- [8] LTR 201807001 (Nov. 13, 2017).

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