Cross-Border Tax Issues Involving Single-Owner Grantor Trusts

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Single-owner grantor trusts arise frequently in cross-border settings. Despite some resemblance to wholly-owned disregarded entities, their treatment could differ significantly for federal income tax purposes. In this report, Zhu sorts through some of these differences under the entity classification rules, income source rules, and income characterization rules. Zhu proposes that we expressly abolish the trust residence rules in existence before the 1996 amendments to section 7701(a)(30) and (31) of the code and that we explicitly disregard a single-owner grantor trust for purposes of determining the federal income tax liabilities of its grantor.

Table of Contents

Outside of the wealth management setting, trusts are less common than other forms of legal entities. As a result, many practitioners not active in wealth management are not as familiar with them, and some may view a single-owner grantor trust (SOGT) as substantially the same as a wholly owned business entity that is a disregarded entity (DE) for federal income tax purposes. However, trusts and SOGTs in particular are more common in nonfamilial business settings than one might first think, and, especially in cross-border settings, SOGTs are substantially more complex than DEs.[1]

This report has two objectives. First, it describes the complexities inherent in: (1) tax classification and reporting, (2) determination of source of income when an SOGT is either a payer or a recipient of an item of income, and (3) income characterization when proper characterization is necessary. Second, it advances two proposals to help reduce some of the complexities: (1) abolishing the concept of trust residence and adopting the idea of trust domesticity; and (2) embracing the rule that, for purposes of determining the federal income tax liability of the grantor and the grantor's direct and indirect owners, an SOGT is disregarded and, in particular, a sale of an interest in an SOGT should be treated in the same way as a sale of an SOGT's assets. The first proposal challenges, and recommends an alternative to, the prevailing view of how the residence-based interest source rule should apply when the payer is a trust debtor. The second proposal is amply supported by several IRS revenue rulings, but arguably inconsistent with at least one court decision that is, however, of uncertain vitality.

The balance of this report is organized in six parts. Part I recaps the basic definitions of an SOGT and a DE. Parts II through IV discuss each of the three areas of complexity. Part V elaborates on the two proposals. Part VI concludes this report.

[1]An analysis of trusts that are either grantor trusts with more than one owner or partial grantor trusts is beyond the scope of this report. In general, this author's view is that the proposals advanced in this report should extend to trusts that are grantor trusts in their entirety. Trusts that are in part grantor trusts and in part nongrantor trusts are more difficult, but they are also much less common in nonfamilial, business settings.

I. Basic Definitions

A. Disregarded Entities

We begin with DEs. Reg. section 301.7701-1(a)(1)[2] provides that ''whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.'' Reg. section 301.7701-1(a)(4) provides that ''under [reg. section 301.7701-2 and -3], certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.''

Reg. section 301.7701-2(c)(2)(i) provides that ''except as otherwise provided in [reg. section 301.7701-2(c)], a business entity that has a single owner and is not a corporation under [reg. section 301.7701-2(b)] is disregarded as an entity separate from its owner.''[3] Under reg. section 301.7701-2(b), the term ''corporation'' includes an association as determined under reg. section 301.7701-3, a foreign entity that is a per se corporation under reg. section 301.7701-2(b)(8), and an entity created or organized under the laws of more than one jurisdiction if it would be treated as a corporation with reference to any single jurisdiction under reg. section 301.7701-2(b)(9). For nearly all purposes of federal income tax, a DE does not exist as a separate entity and is a branch of the owner.[4]

B. Single-Owner Grantor Trusts

In general, a trust is itself subject to tax,[5] allowing for deductions for specified distributions.[6] However, income of a trust is taxed to the grantor if the grantor retains dominion and control over the trust.[7] In this case, ''items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust'' treated as owned by the grantor would be included in computing the tax liability of the grantor.[8] For an SOGT, all of the trust's tax items would be treated as the grantor's.

The statutory language appears to require, first, computation of an SOGT's tax items and, then, inclusion of those items by the grantor.[9] But the ''separate trust computation first'' procedure is not generally required or followed.[10] Under the regulations, ''an item of income, deduction, or credit included in computing the taxable income and credits of a grantor . . . under section 671 is treated as if it had been received or paid *directly* by the grantor . . . (whether or not an individual).''[11] Further, ''if a grantor . . . is treated as the owner of an entire trust . . . he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled *had the trust not been in existence*.''[12] As a result, the line between an SOGT and a DE could appear blurry.

II. Classification and Reporting Issues

A. Classification Issues

SOGTs raise four sets of tax classification issues that for DEs either do not exist or are much easier to deal with: (1) whether an entity cast in trust form is a trust for tax purposes, (2) whether a trust is domestic or foreign, (3) whether a trust is a resident or a nonresident, and (4) whether a trust intended to be an SOGT is an SOGT. Below we briefly discuss each in turn, emphasizing cross-border issues.

1. Trust versus business entity. Only a trust can be an SOGT. The check-the-box regime radically changed the entity classification rules for entities that are organized as trusts but fail the trust qualification requirements.[13] However, the trust qualification requirements remained unchanged.[14]

The trust qualification regs contemplate three general scenarios.[15] First, an ''ordinary trust[16] refers to an arrangement created either by a will or by an inter vivos

[2]In this report, ''code'' refers to the Internal Revenue Code of 1986 as amended. ''Regulations'' refers to the Treasury regulations promulgated under the code. Except as otherwise indicated, ''section'' refers to a section of either the code (for example, section 7701) or the regulations (for example, reg. section 301.7701-2).

[3]Reg. section 301.7701-2(c) provides rules for treating otherwise DEs as separate entities in four scenarios: (1) when the single owner is a bank, reg. section 301.7701-2(c)(2)(ii); (2) when predecessor and some other tax liabilities (or refunds or credits) are involved, reg. section 301.7701-2(c)(2)(iii); (3) when employment taxes other than self-employment taxes are involved, reg. section 301.7701-2(c)(2)(iv); and (4) when some excise taxes are involved, reg. section 301.7701-2(c)(2)(v).

[4]Reg. section 301.7701-2(c)(2)(i). *See supra* note 3.

[5]Section 641.

[6]Sections 651 and 661.

[7]Sections 671 through 679 (subpart E of Part I of subchapter J).

[8]Section 671.

[9]The statutory language requires that grantor trust tax items be computed by reference to the rules applicable to an individual, section 671, even as the grantor owner may be a partnership or a corporation, reg. section 1.671-2(e)(4).

[10]For a case following this procedure or at least this logic, see *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984). However, the continuing vitality of *Rothstein* may be in doubt. *See infra* Part V.B.3.

[11]Reg. section 1.671-2(c) (emphasis added).

[12]Reg. section 1.671-3(a)(1) (emphasis added).

[13]T.D. 8697, 1997-1 C.B. 215, *Doc 96-32369*, *96 TNT 245-1* (finalizing CTB rules). At the time of *Commissioner v. North Am. Bond Trust*, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942), investment trusts that failed as trusts would ordinarily be treated as associations taxed as a corporation. Under the check-the-box regime, nonpublicly traded investment trusts failing the trust classification would be a business entity, and could, either because of the default rules or by election, be taxed as a partnership.

[14]Reg. section 301.7701-4(f) (''The [trust qualification] rules generally apply to taxable years *beginning after December 31, 1960*'') (emphasis added).

[15]Reg. section 301.7701-4(a), (b), and (c). This report does not discuss two types of specialized trusts: liquidating trusts, reg. section 301.7701-4(d), and environmental remediation trusts, reg. section 301.7701-4(e).

[16]Reg. section 301.7701-4(a).

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.''[17]

Second, ''business or commercial trusts'' will be classified as business entities.[18] Those trusts are arrangements cast in a trust form but ''generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships.''[19]

Third, ''investment trusts'' present special classification issues.[20] The general rule is that ''an investment trust will not be classified as a trust if there is power under the trust agreement to vary the investment of the certificate holders.''[21] The prohibition against the ''power to vary'' is stringent. ''A power to vary the investment of the certificate holders exists where there is managerial power, under the trust instrument, that enables the trust to take advantage of variation in the market to improve the investment of the investors.''[22] According to one treatise on securitization transactions, the prohibition ''has been interpreted to preclude *any* power to reinvest trust assets that may be used to take advantage of market variations to improve the investment of certificate holders.''[23]

Although not defined in the regulations, investment trusts potentially encompass most trusts in a nonfamilial business setting and appear frequently in the cross-border context.[24] A private letter ruling states that ''a fixed investment trust is an organization in which a trustee holds the legal title to investment assets for the benefit of multiple beneficiaries.''[25] A treatise states that ''an investment trust is a trust that is formed to hold or manage investments on behalf of beneficiaries who contributed property to the trust, either directly or by purchasing interests in the trust from prior owners.''[26] If the trust tax classification is desired, it would be necessary to ensure that there is no power to vary under the terms of such a trust. However, if the trust tax classification is to be avoided, it can be fairly easily accomplished by breaching the power to vary requirement.[27]

2. Trust domesticity. By domesticity, I mean whether an entity is a U.S. person under section 7701(a)(30) and (31).[28] If an entity organized in trust form is a business entity, the domesticity of the entity follows the ''created or organized'' rule. ''A business entity . . . is domestic if it is created or organized as any type of entity . . . in the United States, or under the law of the United States or of any State.''[29] Business entities with dual domestic and foreign charters are domestic.[30] This tiebreaker rule favors the domestic status of a business entity.

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[17]*Id. See Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986) (settling tax classification of testamentary trusts).

[18]Reg. section 301.7701-4(b). A ''business entity'' is ''any entity recognized for federal tax purposes . . . that is not properly classified as a trust . . . or otherwise subject to special treatment under the Internal Revenue Code.'' Reg. section 301.7701-2(a).

[19]Reg. section 301.7701-4(b).

[20]Reg. section 301.7701-4(c).

[21]*Id.* The general rule has a permissible component. ''An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders.'' *Id.*

[22]Rev. Rul. 2004-86, 2004-2 C.B. 191, *Doc 2004-14855*, *2004 TNT 140-13*.

[23]James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions* 177 (3d ed., 2001, and Supp. No. 7, Nov. 26, 2007) (emphasis in original) [hereinafter Peaslee and Nirenberg].

This author has discussed with a member of the staff at the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) the issue of how the prohibition applied in the context of an SOGT. The staff asserted that, for example, the ability to add a currency hedging instrument to an SOGT already holding an underlying investment that is the subject of the hedge would be construed as a ''power to vary'' and call into question the trust classification of the SOGT. At the same time, he agreed that the grantor could dissolve the SOGT and form a new SOGT with both the underlying investment and the hedging instrument without having the trust classification of the new SOGT being subject to challenge. This author believes that this approach is overly formalistic and that, in the context of an SOGT, the policy reasons behind the prohibition against the ''power to vary'' are substantially diminished as compared with cases involving investment trusts owned by more than one person in which diversification occurs with a mixing of assets contributed by different owners.

[24]*See, e.g.*, Peaslee and Nirenberg, *id.*, ch. 4.D; Eric A. Mazie and Doneene Keemer Damon, ''Role of the Trustee in Leasing Transactions,'' in 1 *Equipment Leasing-Leveraged Leasing*, ch. 9 (Ian Shrank and Arnold G. Gough Jr. eds., 4th ed. 2000).

[25]LTR 9212015 (Dec. 19, 1991). It goes on to require that ''the trust is not actively engaged in trade or business, but is merely a conduit for passing through the investment income to the beneficiaries.'' *See also* LTR 8626030 (Mar. 26, 1986); GCM 37,473 (Mar. 24, 1978).

[26]Peaslee and Nirenberg, *supra* note 23, at 173. It states that ''investment trusts typically issue beneficial ownership certificates that are freely tradable, but it would seem that the term ought to encompass virtually any trust that holds investments and arises in a commercial setting.'' *Id. Cf.* reg. section 1.671-2(e)(3). (''A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in'' reg. section 301.7701-4(d).)

An investment trust for this purpose bears little resemblance to an investment company under section 351, reg. section 1.351-1(c)(1), an investment partnership under section 721(b), or an investment company under section 897, reg. section 1.897-1(f)(3)(ii). The closest analogy may be to an ''investing partnership'' under section 761(a)(1). The definition of an investing partnership contemplates the power to vary but is otherwise more restrictive. Reg. section 1.761-2(a)(2).

[27]*See supra* note 23, *infra* notes 82-84 and accompanying text. The stringency of the prohibition against the power to vary allows investment trusts arising in business settings to, in effect, elect out of the trust classification and makes the check-the-box regime also available to them.

[28]*See* reg. section 301.7701-5 (''domestic and foreign business entities'') and 301.7701-7 (''trusts — domestic and foreign'').

[29]Reg. section 301.7701-5(a).

[30]*Id.*

The rules are more complex for determining the domesticity of a trust. A trust is domestic if it meets both a court test and a control test.[31] The court test is met if ''a court within the United States is able to exercise primary supervision over the administration of the trust.''[32] The control test is met if ''one or more United States persons have the authority to control *all* substantial decisions of the trust.''[33]

Those rules favor the foreign status of a trust. First, both the court test and the control test must be met for a trust to be domestic. Second, to meet the control test, ''*all* substantial decisions of the trust'' must be subject to the authority to control by one or more U.S. persons.[34] Third, the scope of ''substantial decisions'' is broad.[35] Fourth, for ''control'' to exist for any person, ''no other person [could have] the power to veto any of the substantial decisions made by this person.''[36]

The bias in favor of the foreign status has potentially unintended consequences.[37] For example, some nonqualified deferred compensation plans with both foreign nexus and a trust arrangement may need to consider the potential impact of section 409A(b), including the punitive provisions of section 409A(b)(4) and (5).

3. Trust residence. Trust residence is largely a historical notion, and the trust residence rule has no mooring in the code or the regulations at this time. Section 7701(a)(30)(E) and (31)(B) defining trust domesticity were enacted in 1996.[38] The trust residence rule was developed under the prior section 7701(a)(31), when there was no trust domesticity rule.

The prior section 7701(a)(31) provided that ''the term 'foreign trust' mean[s] [a] trust . . . the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.''[39] Under this language, residence turned on how a trust was taxed, and not the other way around. Section 641(b) provides the basic trust taxation rules. Section 641(b) states that ''the taxable income of [a] trust shall be computed in the same manner as in the case of an individual, except as otherwise provided.'' As a result, under the prior section 7701(a)(31), determining whether a trust is a ''foreign trust'' required an analysis of whether the trust was more similar to a nonresident alien individual.

The body of law resulting from this analysis was the trust residence rule. It is a facts and circumstances rule developed through judicial decisions and administrative rulings.[40] The rule focuses on an examination of six factors: (1) jurisdiction under whose laws the trust is created, (2) alienage of the beneficiaries, (3) alienage of the trust settlor, (4) situs of the trust corpus, (5) situs of the trust administration, and (6) residence of the trustees.[41]

The leading case is *B.W. Jones Trust v. Commissioner*,[42] in which a foreign individual created a trust under foreign law for foreign beneficiaries. However, the trust met the last three criteria and was held to be a U.S. resident. Similarly, in Rev. Rul. 60-181,[43] a foreign settlor created a trust under foreign law for foreign beneficiaries. Again, the trust corpus consists principally of U.S. securities held, controlled, and traded on a U.S. stock exchange by a resident trustee. The trust was ruled to be a U.S. resident.

The continuing relevance of the trust residence rule should now be in doubt. Responsible for the rule's genesis, section 641(b) is no longer predicated on it since the removal of the prior section 7701(a)(31). Section 641(b) now operates on the present section 7701(a)(30)(E), that is, the trust domesticity rule.[44] As will be further discussed below, tax rules continue to refer to trust residence. Often, the rules refer to section 7701(a)(30), and these rules now operate under the domesticity rule.

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[31]Section 7701(a)(30)(E).

[32]Section 7701(a)(30)(E)(i). *See* reg. section 301.7701-7(c).

[33]Section 7701(a)(30)(E)(ii) (emphasis added). *See* reg. section 301.7701-7(d).

[34]Section 7701(a)(30)(E)(ii) (emphasis added). *See* reg. section 301.7701-7(a)(1)(ii). Section 1601(i)(3)(A) of the Taxpayer Relief Act of 1997 amended section 7701(a)(30)(E)(ii) by replacing ''fiduciaries'' with ''persons.'' P.L. 105-34, section 1601(i)(3)(A), 111 Stat. 788. This change is important for SOGTs when the grantor may not be a fiduciary.

[35]''Substantial decisions include, but are not limited to, decisions concerning'' the following: (1) whether and when to distribute income or corpus; (2) the amount of any distributions; (3) the selection of a beneficiary; (4) whether a receipt is allocable to income or principal; (5) whether to terminate the trust; (6) whether to compromise, arbitrate, or abandon claims of the trust; (7) whether to sue on behalf of the trust or to defend suits against the trust; (8) whether to remove, add, or replace a trustee; and (9) other powers regarding successor trustee and investment decisions. Reg. section 351.7701-7(d)(1)(ii).

[36]Reg. section 351.7701-7(d)(1)(iii). Further, ''It is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.'' *Id. See supra* note 34.

[37]The excise tax imposed under the prior section 1491 was repealed in 1997 and replaced by section 684. P.L. 105-34, section 1131(a) (repeal) and 1131(b) (replacement), 111 Stat. 788. Section 684 requires, with certain exceptions, gain recognition by the transferor for property transferred to a foreign trust. *Compare* section 684(a) *with* section 1491 (before repeal by P.L. 105-34, section 1131(a), 111 Stat. 788) and section 367(a).

[38]P.L. 104-188, section 1907(a)(1), 110 Stat. 1755, *amended by* P.L. 105-34, section 1601(i)(3)(A), 111 Stat. 788.

[39]Section 7701(a)(30)(E) (before amendment by P.L. 104-188, section 1907(a)(1), 110 Stat. 1755).

[40]For a general discussion, *see, e.g.*, Joel D. Kunz and Robert J. Peroni, 1 *U.S. International Taxation* A2-21 (Warren, Gorham, and Lamont June 2005) [hereinafter Kunz and Peroni].

[41]*Id.*

[42]46 B.T.A. 531 (1942), *aff'd by* 132 F.2d 914 (4th Cir. 1943).

[43]Rev. Rul. 60-181, 1960-1 C.B. 257.

[44]In 1997, section 641(b) was amended to provide that ''for purposes of [section 641(b)], a foreign trust . . . shall be treated as a nonresident alien individual who is not present in the United States at any time.'' P.L. 105-34, section 1601(i)(3)(B), 111 Stat. 788 (effective on Aug. 20, 1996, same day as for amendment of section 7701(a)(30)(E)). This amendment appeared in section 1601(i)(3)(B) of the Taxpayer Relief Act of 1997, and section 1601(i)(3)(A) of same law put section 7701(a)(30)(E) in its current form. *See supra* note 34.

Some, including section 641(b) itself, do not include an express cross reference to section 7701(a)(30) and are therefore less certain.

4. Grantor trust status in cross-border content. In the cross-border context, special care must be taken when a trust desires grantor trust status with a foreign grantor. Under section 672(f), the grantor trust rules apply ''only to the extent such application results in an amount (if any) being currently taken into account (directly or through [one] or more entities) . . . in computing the income of a citizen or resident of the United States or a domestic corporation.''[45]

Three important exceptions to this no-foreign-owner rule are as follows: (1) a controlled foreign corporation is treated as a domestic corporation for this purpose[46]; (2) the rule does not apply to any portion of a trust if ''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''[47]; and (3) the rule does not apply to a nonexempt employees' trust described in section 402(b).[48]

The impact of the no-foreign-owner rule is reduced under the current domesticity rule. Trusts likely to be affected by section 671(f) are, now, also likely to be foreign trusts. Although it is possible that the federal income tax consequences do not depend in important ways on whether a foreign trust is an SOGT with a foreign grantor, state tax consequences must be considered separately.[49]

B. Reporting and Other Issues

1. Trust reporting obligations. Generally, a domestic trust must file Form 1041 (and a foreign trust must file Form 1040NR).[50] However, an SOGT does not include its tax items on Form 1041, but rather reports those items on a separate statement attached to it (or to Form 1040NR in the case of a foreign trust).[51] Also, SOGTs have two other options. They may (1) provide the name and taxpayer identification number of the owner and the address of the trust to all payers[52] during the tax year and comply with the additional requirements in reg. section 1.671-4(b)(2)(ii), *or* (2) provide the name, TIN, and address of the trust to all payers during the tax year and comply with the additional requirements in reg. section 1.671-4(b)(2)(iii). Under reg. section 1.671-4(b)(2)(ii), the trustee must provide the owner with certain information regarding income of the trust *but* is not required to file any return with the IRS. Under reg. section 1.671-4(b)(2)(iii), the trustee must provide the owner substantially the same information regarding income of the trust *and* is required to file Form 1099 with the IRS.[53]

In the cross-border context, many SOGTs cannot use either option. Grantor trusts prohibited from using either option include any trust with its situs or any of its assets located outside the United States and any trust wholly owned by a person who is not a U.S. person.[54]

2. A limited liability company owned by an SOGT and its owner. In a private letter ruling, the IRS held that an LLC wholly owned by an SOGT and its owner would be disregarded.[55] The LLC could not be treated, or report, as a partnership. This ruling parallels a recent revenue ruling in which the IRS concluded that a domestic LLC wholly owned by a DE and its owner also could not be classified as a partnership.[56]

III. Income Source Rules

A. Income From a Sale of Personal Property

In general, section 865 sources income from the sale of personal property according to whether the taxpayer is a U.S. resident.[57] For this purpose, section 865(g)(1)(A)(ii)

[45]Section 671(f)(1); reg. section 1.671(f)-1.

[46]Section 671(f)(3)(A). Also, section 671(f)(1) does not apply for purposes of section 1297 dealing with whether a foreign corporation is a passive foreign investment company. Section 671(f)(3)(B); reg. section 1.672(f)-2(a).

[47]Section 671(f)(2)(A)(i).

[48]Section 672(f)(2)(B); reg. section 1.672(f)-3(c)(l)(i). *But see* prop. reg. section 1.671-1(g) (applying no look-through rule to employer grantor of domestic nonexempt employees' trust) and prop. reg. section 1.671-1(h) (same for foreign nonexempt employees' trust with exceptions). The proposed regulations apply for tax years of an employer ending after September 27, 1996. Prop. reg. section 1.671-1(h)(9). *See also* Rev. Rul. 2007-48, 2007-30 IRB 129, *Doc 2007-15695*, *2007 TNT 128-3* (applying no look-through rule without referring to proposed regulations).

[49]For example, the income of a trust, even if a foreign trust under the federal rules, is subject to California tax if any trustee is a California resident. Ca. Rev. & Tax'n Code section 17742. However, if the trust is an SOGT, California tax rules would apply to the owner, and not the trust, and the residence of the trustee becomes irrelevant. Ca. Rev. & Tax'n Code section 17731(a).

[50]IRS 2007 Instructions for Form 1041, at p. 4.

[51]Reg. section 1.671-4(a).

[52]Reg. section 1.671-4(b)(4) (defining the term ''payor'').

[53]Under the first alternative, the payers are provided with owner information and the trust does not file information returns with the IRS. Under the second alternative, the payers are provided with trust information and the trust must file information returns with the IRS.

[54]Reg. section 1.671-4(b)(6)(ii) and (v). Reg. section 1.671-4(b)(6)(iv) provides that neither option is available to a trust all of which is treated as owned by one grantor whose tax year is a fiscal year. As a result, this rule imposes a filing obligation on such an SOGT even as all of its tax items are included as those of its grantor owner and its tax year otherwise disregarded. Rev. Rul. 90-55, 1990-2 C.B. 161; Rev. Rul. 57-390, 1957-2 C.B. 326.

[55]LTR 200102037 (Oct. 12, 2000), *Doc 2001-1377*, *2001 TNT 10-56*. The owner represented that the LLC would not make an election to be treated as an association taxed as a corporation, and would be classified according to the default rules under reg. section 301.7701-3. Presumably, the LLC is domestic.

[56]Rev. Rul. 2004-77, 2004 C.B. 119, *Doc 2004-15662*, *2004 TNT 148-7*.

[57]Section 865(a). This general rule is subject to many exceptions. *See* section 865(b) (inventory property, including especially unprocessed timber), 865(c) (depreciable personal property), 865(d) (intangible property), 865(e) (sales through U.S. office or fixed place of business) and 865(f) (sale of stock of affiliates).

defines the residence of a trust by reference to section 7701(a)(30). As a result, such income would be foreign-source income if earned by a foreign trust and U.S.-source income if earned by a domestic trust.

Section 865(g) was enacted in 1986,[58] before section 7701(a)(30)(E) was amended in 1996 to provide the new domesticity rule. Before the amendment, section 865(g) was construed based on the trust residence rule. However, with its express reference to section 7701(a)(30), section 865(g)(1)(A)(ii) should now conform to the trust domesticity rule.[59]

For an SOGT, however, issues arise regarding whether section 865(g) should be applied by reference to the residence of the trust, which favors foreign source, or to the residence of the grantor, which may not.[60]

B. Income Under Section 988 and NPCs

Section 988 imposes a separate income characterization rule[61] for any foreign currency gain or loss attributable to a "section 988 transaction."[62] It also has its own source rule. The source of that income is determined by reference to the residence of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected.[63] The same residence-based source rule also applies to income attributable to some notional principal contracts (NPCs).[64]

For this purpose, residence of a trust is, again, determined under section 7701(a)(30).[65] Section 988 itself was enacted in 1986.[66] Regulations on the source rule under section 988 were finalized in 1992,[67] and regulations on the source rule for NPC income were finalized in 1991.[68] However, given the specific reference to section 7701(a)(30) in section 988(a)(3)(B)(i)(II),[69] the change to section 7701(a)(30) requires conformity in section 988.

For a withholding agent, the source rule for such income under an NPC may be irrelevant. "A withholding agent that pays amounts attributable to a notional principal contract described in [reg. sections] 1.863-7(a) or 1.988-2(e) shall have no obligation to withhold on the amounts paid under the terms of the [NPC] regardless of whether a withholding certificate is provided."[70] But the source rule remains critical for determining a foreign taxpayer's substantive tax liability.[71]

SOGTs again present a potential ambiguity when the residence of the trust and the residence of the grantor differ.[72]

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[58]P.L. 99-514, section 1211(a), 100 Stat. 2085.

[59]Section 7701(a), including section 7701(a)(30) and (31), applies to the entire code "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." Section 7701(a).

[60]This author's view is that, for an SOGT, the source rule should apply at the grantor level. *See infra* Part V.B. For partnerships, section 865 "shall be applied [on the look-through basis] at the partner level." Section 865(i)(5).

[61]Section 988(a)(1).

[62]The term "section 988 transaction" means principally certain debt or financial instrument transactions if the amount that the taxpayer is entitled to receive (or required to pay) by reason of such a transaction is determined in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. Section 988(c)(1).

[63]Section 988(a)(3)(A).

[64]Reg. section 1.863-7(b)(1) (providing that in general, the source of NPC income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i)). Plainly a section 988 transaction could by itself involve an NPC. *See* reg. section 1.988-2(e).

[65]Section 988(a)(3)(B)(i)(II).

[66]P.L. 99-514, section 1261(a), 100 Stat. 2085.

[67]Reg. section 1.988-4(d). T.D. 8400, 1992-1 C.B. 101.

[68]T.D. 8330, 1991-1 C.B. 105. As a result, the NPC source rule regulations refer only to the statutory provisions of section 988, and not the section 988 source rule regulations.

[69]*See also* reg. section 1.988-4(d)(1)(ii) (referring to section 7701(a)(30)). *See supra* note 59.

[70]Reg. section 1.1441-4(a)(3)(i). If that income is fixed or determinable annual or periodic income (FDAPI), *see infra* note 71, sections 1441 and 1442 appear to require withholding on any FDAPI absent an exemption, and it is not clear whether there was statutory authority for the blanket nonwithholding rule provided in the regulations.

[71]The determination of FDAPI under section 881(a) is the same as that under reg. section 1.1441-2(a). Reg. section 1.881-2(b). FDAPI "includes all income included in gross income under section 61 (including original issue discount) except for the items specified in [reg.] section 1.1441-2(b)(2)." Reg. section 1.1441-2(b)(1)(i). The only exception provided is "gain derived from the sale of property." *Id.* (also providing exceptions to this exception). Also, any other income determined by the IRS in published guidance not to be FDAPI will also be excepted, reg. section 1.1441-2(b)(2)(ii), and "items that are excluded from gross income under a provision of law without regard to the U.S. or foreign status of the owner of the income . . . shall not be treated as" FDAPI, reg. section 1.1441-2(b)(1)(i). Under this expansive definition, the ongoing payments made during the term of an NPC would appear to be FDAPI. That appears to be the position taken in final regulations. T.D. 8734, 1997-2 C.B. 109, *Doc 97-27932*, *97 TNT 194-9* (Section E of Explanation of Provisions and Revisions) (describing the general nonwithholding rules of reg. section 1.1441-4(a)(3) as measures that "minimize the burden associated with characterizing the [NPC] income as" FDAPI).

However, the income under an NPC does not have a high net-income component, and therefore is not of the type typically targeted by the withholding regime. *See* Harvey P. Dale, "Withholding Tax on Payments to Foreign Persons," 36 *Tax L.R.* 49, 59 (1980).

[72]For an SOGT, this author's view is that the source rule should apply according to the residence of the grantor. *See infra* Part V.B. One treatise states, without a specific citation, that "a non-U.S. investor that owns an interest in an NPC through a grantor trust clearly would benefit from [the] source rule [under reg. section 1.863-7(b)], since the trust would be ignored." Peaslee and Nirenberg, *supra* note 23, at 755.

C. Interest Payments Made by a Trust

Residence of a trust also enters section 861(a)(1), the interest source rule. Section 861(a)(1) provides that interest from a noncorporate resident (or a domestic corporation[73]) is U.S.-source income. Section 862(a)(1)(i) provides that interest income other than that described in section 861(a)(1) is not U.S.-source income. Reg. section 1.861-2 elaborates on the interest source rule but does not provide any specific rule for trusts.[74]

The standard reference books use the trust residence rule developed before the introduction of the trust domesticity rule in applying the interest source rule.[75] In this author's view, the position is questionable.[76] SOGTs present the additional ambiguity when the residence of the trust, however determined, and the residence of the grantor differ.[77]

IV. Income Characterization Issues

A. Subpart F Income Issues

A U.S. shareholder of a CFC owning, directly or indirectly through a foreign entity, stock in the CFC must include its pro rata share of the CFC's subpart F income.[78] In general, any gain from the sale of an interest in a trust is subpart F income.[79] There is, however, no direct authority on whether a CFC's gain from the sale of an interest in an SOGT[80] would be considered per se subpart F income or treated on the look-through basis as income from a sale of assets owned by the SOGT, which may or may not be subpart F income.

Although not directly on point, two recent cases are worth describing. First, in *Dover Corp. v. Commissioner*,[81] the Tax Court upheld the taxpayer's check-and-immediate-sale subpart F planning. In *Dover*, a CFC sold a wholly owned non-U.S. subsidiary to an unrelated party. Gain from the sale of stock would ordinarily be subpart F income under section 954(c)(1)(B)(i). The CFC in *Dover* made a (retroactive) check-the-box election to change the tax classification of the subsidiary from a corporation to a DE, effective immediately before the sale, and took the position that the sale of the subsidiary stock should, for U.S. tax purposes, be treated as a sale of the subsidiary's assets, the income from which may not be subpart F income.

Dover has no bearing on characterization of income from the sale of an SOGT, but the taxpayer's approach is helpful for comparison. In the case of a business entity, the DE status could be achieved through a check-the-box election with little or no non-U.S. tax consequences.[82] An SOGT, however, is not a business entity and cannot elect to be disregarded under the CTB rules. Although an SOGT may consider distributing its assets to the grantor and dissolving, the distribution/dissolution procedure may have foreign tax consequences. Nontax issues could also be important. Often, a trust including an SOGT is used in part to avoid the need for transferring the underlying assets when a transfer of an investment is necessary.[83] Most SOGTs do not have an at-will reversionary provision for the benefit of the grantor, and may not permit such a procedure even if it yielded no adverse foreign tax consequences.[84] In light of *Dover*, when the use of a trust is appropriate for nontax reasons, taxpayers should consider breaching the ''power to vary'' prohibition, which should render an investment trust a business entity subject to the CTB rules.

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[73]*See also* section 884(f) (treating interest allocable to a foreign corporation's income effectively connected with U.S. trade or business carried out by foreign corporation as paid by domestic corporation).

[74]Reg. section 1.861-2(a)(1) (restating ''interest from a resident of the United States'' is U.S.-source income) and reg. section 1.861-2(a)(2) (defining resident of the United States without specific provisions for trusts).

[75]*See, e.g.*, Kunz and Peroni, *supra* note 40, A2-21 to A2-22; Peter H. Blessing and Gregory P. Lubkin, *Source of Income Rules*, 905-2d Tax Management Portfolio at A-17 to A-18 (2007, C&A June 9, 2008).

[76]*See infra* Part V.A.

[77]For an SOGT, this author's view is that the source rule should apply according to the residence of the trust and, as a result, this ambiguity would not manifest itself. *See infra* Part V.B.4.

[78]Section 951(a)(1). Income inclusion is required only if (1) the foreign corporation is a CFC for an uninterrupted period of at least 30 days during a tax year, and (2) the U.S. shareholder owns, directly or indirectly through a foreign entity, stock in the CFC on the last day of the foreign corporation's tax year on which the foreign corporation is a CFC. Section 951(a)(1). The term ''U.S. shareholder'' is defined in section 951(c). It requires ownership of voting stock in the CFC but, for purposes of determining whether a U.S. person is a U.S. shareholder, ''ownership'' includes not only direct and indirect (through a foreign entity) ownership but also constructive ownership. Sections 951(c), 958(a), and 958(b). For a useful discussion, see *Textron Inc. v. Commissioner*, 117 T.C. 67 (2001), *Doc 2001-22287*, *2001 TNT 163-7*.

[79]Section 954(c)(1)(B)(ii) (specifying income from sale of interest in trust to be foreign personal holding company income). Subpart F income includes foreign base company income as defined in section 954. Section 952(a)(2). Foreign base company income includes foreign personal holding company income. Section 954(a)(1).

[80]Recall that for purposes of section 672(f), a CFC is treated as a dometic corporation, and therefore would not be subject to the no-foreign-owner rule. Section 672(f)(3)(A); reg. section 1.672(f)-2(a).

[81]*Dover Corp. v. Commissioner*, 122 T.C. 324 (2004), *Doc 2004-9660*, *2004 TNT 88-15*.

[82]122 T.C. at 347, n.15 (no U.K. tax consequences from CTB election). This assumes the business entity is an eligible entity. Reg. section 301.7701-3(a)(1).

[83]*See, e.g.*, Ian Shrank, ''Basics of Leasing and Glossary,'' *in* 1 *Equipment Leasing-Leveraged Leasing* at 2-22 (Ian Shrank and Arnold G. Gough Jr. eds., 4th ed., 2000) (using trusts in equipment leasing for ease of transferability of equity interests to help avoid transfer tax and government filings which may be required if underlying assets are transferred).

[84]*See, e.g.*, section 676 (power to revest trust property in grantor being merely one of several grantor trust triggers); *Ringwalt v. United States*, 549 F.2d 89 (8th Cir. 1977) (ascertaining grantor trust status under section 677(a)(2) based on power to allocate trust receipts between income and principal the latter of which may be distributed to grantor).

Second, in *Textron Inc. v. Commissioner*,[85] the Tax Court considered the case of an SOGT wholly owned by Textron Inc., a domestic corporation.[86] The SOGT owned substantially all the stock of a U.K. company and earned subpart F income. The Tax Court held that Textron is not the U.S. shareholder required to include the subpart F income, because Textron did not own any stock in the U.K. company either directly or indirectly through a foreign entity,[87] but that the SOGT is a U.S. shareholder required to include the subpart F income and any such income is attributed to the grantor and must be included in computing Textron's income tax.[88]

Although closer to the issue at hand, *Textron* does not deal with subpart F income characterization of gain from a sale of an interest in an SOGT. Nevertheless, in treating an SOGT and its grantor separately in the subpart F context, *Textron* lends some credence to the concern that a sale of an interest in an SOGT by the grantor may be treated differently from a sale by an SOGT of all of its assets.[89]

B. Passive Foreign Investment Company Issues

A foreign corporation meeting either a passive income test or a passive asset test is a passive foreign investment company.[90] Like a CFC, a PFIC is generally treated as a domestic corporation and is not subject to the no-foreign-owner rule under section 672(f).[91] Complications arise in applying both the income test and the asset test when a foreign corporation owns an SOGT, none of which exists if the SOGT is replaced with a DE.

Regarding the income test, the PFIC rules define the term ''passive income'' by reference to section 954(c),[92] and have the same ambiguity as do the CFC/subpart F rules when a foreign corporation sells an interest in an SOGT.[93]

Regarding the asset test, it is not clear whether the test should be applied to the interest in an SOGT itself as the asset, or applied on a look-through basis to the underlying assets owned by the SOGT.[94]

If the interest in the trust is itself the asset, and the trust produces income treated as directly earned by the foreign corporation, the interest in the trust would presumably be divided between an active asset component and a passive asset component in accordance with the division of the trust income.[95] If the trust does not produce any income in any given year, it is not clear how to apply the asset test to the interest in the SOGT.[96]

If the underlying assets owned by the SOGT are the relevant assets, the asset test would apply on the look-through basis as if the SOGT did not exist.

C. Income Characterization Under Section 892

Subpart F/PFIC rules do not exhaust SOGT-related income characterization issues in cross-border settings. As an example, a foreign government's income from investments in securities is generally excluded from gross income under section 892. The term ''securities'' for this purpose does not include trust interests.[97] Also, ''gain on the disposition of an interest in . . . a trust is not [income from investments in securities and therefore is not] exempted from taxation under section 892.''[98]

In a private letter ruling, the IRS held that ''for purposes of section 892 of the Code, investments made

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[85] *Textron Inc. v. Commissioner*, 117 T.C. 67 (2001).

[86] The trust instrument provided that Textron would have no influence over the management of the stock in the SOGT, including especially with respect to voting. Textron is the only person entitled to any income from the trust, and the trust was determined to be a grantor trust under section 677. *Id.* at 77-78.

[87] *Id.* at 75.

[88] *Id.* at 78-79.

[89] In this author's view, that gain should not be per se subpart F income under section 954(c)(1)(B)(ii). *See infra* Part V.B.

[90] Section 1297(a).

[91] Section 672(f)(3)(B); reg. section 1.672(f)-2(a) and -2(c).

[92] Section 1297(b)(1) (referring to sections 954(c) and 1297(b)(2)) (providing exceptions).

[93] In this author's view, any such gain should not be per se passive income. *See infra* Part V.B.

In one important aspect, the PFIC rules differ from the CFC rules. Under the CFC rules, the income characterization does not change whether a foreign corporation would be a CFC, and would affect how much of a CFC's income is subpart F income subject to income inclusion by specified U.S. shareholders. Under the PFIC rules, the income characterization is part of the definitional rules. The PFIC definitional rules need to be applied on an annual basis, under the shadow of the ''once a PFIC, always a PFIC'' rule. Section 1298(b)(1).

[94] In this author's view, the passive asset test should be applied to an SOGT's underlying assets. *See infra* Part V.B.

As a result, section 1297(c) should apply when a portion of the ownership interests in the 25 percent subsidiary is owned through an SOGT. *Cf.* LTR 200604020 (Oct. 21, 2005), *Doc 2006-1630*, *2006 TNT 19-37* (treating sale of stock of 25 percent subsidiary as sale of a pro rata portion of subsidiary's assets for passive income test purposes without specifying whether indirect ownership includes ownership through partnership or trust).

Although beyond the scope of this article, a similar ambiguity exists for partnership interests owned by a foreign corporation.

In contrast to the definitional rules, the PFIC ownership attribution rules provide for look-through treatment from a foreign trust to a U.S. beneficiary. Section 1298(a)(3). Legislative history provides that attribution is to the grantor, and not the beneficiary, when the trust is a grantor trust. ''General Explanation of the Tax Reform Act of 1986,'' at 1032 (Joint Comm. on Tax'n 1987). (''In attributing stock owned by a trust, it is intended that the general rules of subchapter J apply. That is, in the case of a grantor trust, any stock owned by the trust generally shall be attributed to the grantor of the trust, and any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust.'')

[95] Notice 88-22, 1988-1 C.B. 489 (providing asset characterization rules for assets generating both passive and nonpassive income).

It is not clear whether, in this case, the look-through rule for 25 percent owned subsidiaries under section 1297(c) would apply in the event the indirect ownership is through an SOGT. *See id*.

[96] This problem is exacerbated by the requirement that the asset test be applied on the average-of-end-of-each quarter basis, Notice 88-22, 1988-1 C.B. 489, and so could present itself if the trust does not produce income in any given quarter.

[97] Reg. section 1.892-3T(a)(3).

[98] Reg. section 1.892-3T(a)(2).

by and activities carried on by a trust created by a foreign government will be treated as if directly made by or carried on by the foreign government grantor if such trust is classified as a grantor trust.''[99] As a result, income attributed to a foreign government grantor from an SOGT should not be disqualified solely because interests in trusts are generally not securities under section 892. It is less clear, however, whether a foreign government's gain from a sale of its interest in an SOGT would also be eligible for exclusion under section 892.[100]

V. Two Proposals

A. The First Proposal

Without clear statutory or regulatory guidance to the contrary, we should expressly abolish the body of law defining trust residence and adopt the trust domesticity rule whenever a tax rule refers to trust residence.

1. The 1996 amendments. In introducing the trust domesticity rule, Congress intended for it to replace the residence rule. The 1996 amendments to section 7701(a)(30) and (31) were but a part of a comprehensive effort to address ''foreign trust tax compliance'' issues.[101] Issues addressed include ''information reporting on foreign trusts,''[102] ''penalties for failure to file return relating to transfers to foreign entities,''[103] ''rules relating to foreign trusts which are not grantor trusts,''[104] and, finally, ''residence of trusts.''[105] Under prior law dealing with residence of trusts, the Joint Committee on Taxation stated that ''a trust was treated as foreign if it was not subject to U.S. income taxation on its income that was neither derived from U.S. sources nor effectively connected with the conduct of a U.S. trade or business. . . . Thus, if a trust was taxed in a manner similar to a nonresident alien individual, it was considered to be a foreign trust. Any other trust was treated as domestic.''[106] Under ''reasons for change'' dealing with ''residence of trusts,'' the JCT stated that ''because the U.S. tax treatment of a trust (and beneficiaries of a trust) depend on the residence of the trust, the Congress believed that it is appropriate to provide objective criteria for determining the residence of trusts.''[107] Finally, under ''explanation of provisions'' dealing with ''residence of trusts,'' the JCT stated that the new law ''establishes a two-part objective test for determining for tax purposes whether a trust is foreign or domestic.''[108] It seems clear that the new domesticity rule was introduced as a residence rule and that there would be no other residence rule left thereafter. In the face of this comprehensive effort, to continue to use the facts-and-circumstances residence rule appears problematic or worse.

The transitional relief granted after the 1996 amendments to trusts that were domestic trusts under the residence rule but that would be foreign trusts under the domesticity rule also makes it clear that the domesticity rule operates to replace the residence rule and not operate in tandem with it.[109] In providing the transitional relief, Notice 96-65 pointedly referred to Rev. Rul. 60-181[110] and *B.W. Jones Trust v. Commissioner*[111] and clearly indicated that the body of law represented by these authorities was being replaced by the ''more objective'' domesticity rule.

2. The interest source rule. In light of the foregoing, there appears to be insufficient support for continuing to base the interest source rule involving a trust debtor on the old trust residence rule. The hornbook position was operative before the current trust domesticity rule was introduced, but the argument that the same position must continue to hold merely because no statutory or regulatory changes were made under section 861 regarding trust debtors is not persuasive.[112]

On a close read, the section 861 regulatory language comports better with the domesticity-based source rule than with the residence-based source rule. The detailed trust-related rules were left out of the section 861 regulations because they were intended to follow the individual-related rules. Regarding individuals, reg. section 1.861-2(a)(2) provides that ''the term 'resident of the United States' . . . includes . . . an individual who at the time of payment of the interest is a resident of the United States.'' Section 641(b) directly states that, for purposes of section 641(b), a foreign trust — determined under the domesticity rule and not the old residence rule — is to be treated as a *nonresident* individual.

Moreover, applying the individual-based rules from the regulations to a trust requires a determination of the

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[99]LTR 9120031 (Feb. 22, 1991).

[100]In this author's view, it should. *See infra* Part V.B. *But see* LTR 9643031 (Oct. 25, 1996), *Doc 96-28731*, *96 TNT 210-35* (holding that foreign government's distributive share of passive investment income in securities from partnership eligible for exclusion under section 892 but foreign government's income from sale of partnership interest not eligible).

[101]P.L. 104-188, sections 1901 through 1907 (Subtitle I of the Small Business Job Protection Act of 1996), 110 Stat. 1755.

[102]*Id.*, section 1901.

[103]*Id.*, section 1902.

[104]*Id.*, section 1906.

[105]*Id.*, section 1907.

[106]''General Explanation of the Tax Legislation Enacted in the 104th Congress,'' at 267-268 (Joint Comm. on Tax'n 1996).

[107]*Id.* at 270.

[108]*Id.* at 273-274.

[109]Notice 96-65, 1996-2 C.B. 232, *Doc 96-31681*, *96 TNT 238-4*. *See* section 1491 (before repeal by P.L. 105-34, section 1131(a), 111 Stat. 788). The prior section 1491 imposed an excise tax on a transfer of property by a domestic trust to a foreign trust, which could be triggered when a domestic trust became a foreign trust. The prior section 1491 was repealed in 1997. P.L. 105-34, section 1131(a), 111 Stat. 788.

[110]Rev. Rul. 60-181, 1960-1 C.B. 257.

[111]46 B.T.A. 531 (1942).

[112]The same argument would lead to the conclusion that the domesticity rule also would not apply for section 641, which cannot be the right result.

The situation is different for partnership debtors for which reg. section 1.861-2(a)(2) provides a specific definition of residence and for which there has been no statutory redefinition. *See* Jonathan Zhu, ''Partnership-Related Withholding Rules for Interest Payments,'' *Tax Notes*, Nov. 7, 2005, p. 820, *Doc 2005-21760*, or *2005 TNT 215-37* (summarizing statutory and legislative history in describing some partnership-related source rule issues under section 861(a)(1)).

trust residence "at the time of payment." But the trust residence rule is based on an annualized determination or at least analysis over an extended period of time.[113] In contrast, under the domesticity rule, "a trust is a United States person for purposes of the [code] *on any day* that the trust meets both the court test and the control test."[114] "A foreign trust . . . shall be treated as a nonresident alien individual who is not present in the United States *at any time*."[115] The day-by-day determination of trust domesticity permits the regulatory language to operate as it is written.

Based on the foregoing, this author believes that the interest source rule involving a trust debtor should be based on the domesticity rule. As a result, interest payments made by a U.S. trust under section 7701(a)(30)(E) is U.S.-source income to the recipient, and interest payments made by a foreign trust under section 7701(a)(31)(B) is non-U.S.-source income to the recipient.

Because of the foreign bias of the trust domesticity rule, it is possible for a trust, which would be a resident under the six-factor residence rule, to be a foreign trust under the domesticity rule. Because a withholding agent who underwithholds has very limited recourse,[116] the withholding agent may opt to be conservative and, for now, take into account both the hornbook position and this author's view. However, were the trust to overwithhold, the recipient should be able to seek a refund for the amount overwithheld.[117]

B. The Second Proposal

Without clear legislative intent or regulatory guidance to the contrary, we should disregard an SOGT for purposes of determining the federal income tax liabilities of the grantor and the grantor's direct and indirect owners.

1. IRS administrative position. The IRS has, for a long time, and in a variety of contexts, taken the position that the grantor of an SOGT is treated as the direct owner of the trust assets. Below are a few examples:

- a taxpayer may undertake an exchange under section 1031 of real property for interests in a grantor trust owning real property in which he retains an interest as a grantor despite the prohibition against any exchange of certificates of trust of beneficiary interests under section 1031(a)(2)(E);[118]
- the tax year of an SOGT is not required to be the calendar year under section 644(a);[119]
- a certificate holder in an investment trust that is a grantor trust does not recognize gain or loss when the certificates are exchanged for a proportionate share of each of the trust's assets;[120]
- an SOGT's purchase of replacement property for property of the grantor that has been involuntarily converted into money can qualify the grantor's gain for nonrecognition under section 1033;[121]
- the transfer of appreciated property to a foreign SOGT is not subject to the excise tax imposed under the prior section 1491 when the transferor is the grantor;[122]
- a commodity futures exchange clearing house corporation may not deduct contributions made to an SOGT established for the purpose of protecting customers of the exchange from financial loss due to the insolvency of any of the clearing members;[123] and
- a corporate grantor is entitled to a dividends received deduction under section 243 on dividends received from stock held by the SOGT.[124]

Three aspects of these rulings are worth noting. First, the direct-ownership-of-trust-assets view has been applied in the cross-border context.[125] Second, the IRS appears to have hewed to this view with increasing vigor, overruling several prior inconsistent rulings.[126] Third, several rulings disregard the trust when assets are exchanged for an interest in an SOGT, and go beyond the narrower context of treatment of an SOGT's tax items in the hands of the grantor while the SOGT is wholly owned by the grantor.[127]

2. Extension of the IRS administrative position. The rulings cited above are by no means exhaustive. Although they do not directly address the income characterization from a sale of an interest in an SOGT, those rulings, especially those dealing with exchanges of assets for interests in SOGTs, clearly and strongly support the view that, for purposes of determining the grantor's federal income tax liability (or that of the grantor's direct and indirect owners), a sale of an interest in an SOGT

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[113] *See, e.g.*, *B.W. Jones Trust v. Commissioner*, 132 F.2d 914 (4th Cir. 1943) (transient stay in United States insufficient for residence).

[114] Reg. section 301.7701-7(a)(2) (emphasis added).

[115] Section 641(b). *See also* reg. section 301.7701-7(a)(3). ("Section 7701(b) is not applicable to trusts because it only applies to individuals. In addition, a foreign trust is not considered to be present in the United States at any time for purposes of section 871(a)(2).")

[116] *See* Harvey P. Dale, "Withholding Tax on Payments to Foreign Persons," 36 *Tax L.R.* 49, 77-95 (1980).

[117] Reg. section 1.1464-1(a).

[118] Rev. Rul. 2004-86, 2004-2 C.B. 191.

[119] Rev. Rul. 90-55, 1990-2 C.B. 161. Section 644 was enacted in 1986. P.L. 99-514, section 1403(a), 100 Stat. 2085. The IRS ruled earlier that the tax year of, and the method of accounting used by, an SOGT should be disregarded, and the gross income from the trust properties must be determined by the grantor-corporation as if the trust had not been created. Rev. Rul. 57-390, 1957 C.B. 326.

[120] Rev. Rul. 90-7, 1990-1 C.B. 153, revoking Rev. Rul. 68-633, 1968-2 C.B. 329.

[121] Rev. Rul. 88-13, 1988-2 C.B. 304.

[122] Rev. Rul. 87-61, 1987-2 C.B. 219, revoking Rev. Rul. 69-450, 1969-2 C.B. 168.

[123] Rev. Rul. 85-158, 1985-2 C.B. 175. Similarly, a corporation may not deduct contributions made to an SOGT formed to pay its obligations to its employees under a state's workers compensation laws (but may deduct payments of benefits to employees when made). Rev. Rul. 82-95, 1982-1 C.B. 101.

[124] Rev. Rul. 66-72, 1966-1 C.B. 58.

[125] Rev. Rul. 87-61, 1987-2 C.B. 219. *See supra* text accompanying note 122.

[126] *See supra* text accompanying notes 120 and 122.

[127] *See, e.g.*, Rev. Rul. 2004-86, 2004-2 C.B. 191; Rev. Rul. 90-7, 1990-1 C.B. 153; Rev. Rul. 88-13, 1988-2 C.B. 304. *See supra* text accompanying notes 118, 120, and 121.

should be treated in the same way as a sale of the SOGT's assets and that, more generally, an SOGT should be treated in the same way as a DE.

Indeed, a taxpayer taking this view may prevail on the argument that, given the rulings, the IRS would not be permitted to argue the contrary view.[128] The ''principles and public guidance''[129] expressed in those rulings seem consistent and clear. In 2004 the IRS stated that ''because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, [grantors] are each considered to own an undivided fractional interest in [assets in the grantor trust] *for federal income tax purposes*.''[130] In 1990 the IRS stated that ''when a grantor is treated as the owner of an entire trust, the grantor is considered to be the owner of the trust assets *for federal income tax purposes*.''[131] Both of those rulings rely on a 1985 ruling that stated, again, that ''because [the grantor] is treated as the owner of the entire trust, [the grantor] is considered to be the owner of the trust assets *for federal income tax purposes*.''[132] Under such ''principles and public guidance,'' a sale of an interest in an SOGT should be treated as a sale by the grantor of the trust assets, and not as a sale by the grantor of an interest in a trust which is not a grantor trust.

Under this view, (1) gain from a sale of an interest in an SOGT would not, under section 954(c)(1)(B)(ii), be per se subpart F income, (2) the same gain would not, under section 1297(b)(1), be per se passive income, (3) an interest in an SOGT would not itself be the asset subject to the passive asset test under section 1297(a)(2), and (4) gain from a sale of an interest in an SOGT would not be per se ineligible for income exclusion under section 892.

3. Two cases. Even with several administrative pronouncements on the books, an express adoption of the present proposal would lend much welcome certainty for taxpayers without any apparent detriment to the IRS. Greater certainty is helpful in light of two cases that cast some doubt on whether an SOGT could be equated with a DE for purposes of determining the federal income tax liability of the grantor (and, in CFC/subpart F and PFIC contexts, that of the grantor's direct or indirect owners). The first is *Textron*, which is discussed above.[133] The Tax Court did not, for purposes of section 958(a), treat a grantor as the owner of the assets held in an SOGT. However, it held that the grantor must include all SOGT's subpart F income under the grantor trust rules, and the result to the grantor was the same.

The second is *Rothstein v. United States*.[134] In *Rothstein*, the Second Circuit held that a loan between an SOGT and the grantor should be given substance as a separate transaction. Although not a formal part of the holding, it also stated that a sale between an SOGT and the grantor should be given substance. The holding and the statement are based on the ''separate trust computation first'' concept emanating from the language of section 671,[135] and are inconsistent with the present proposal.

The continuing vitality of *Rothstein* is in doubt, at least outside the Second Circuit. The IRS has stated that it would not follow *Rothstein*, and would disregard any transaction entered into between an SOGT and its grantor.[136] In taking this position, the IRS interpreted section 671, requiring inclusion by the grantor of the SOGT's tax items, as a reflection of the principle that the grantor is treated as the owner of the trust assets by exercising dominion and control over the trust, and not as a limitation to the ramifications of the principle.[137] The Tax Court referred to *Rothstein* in *Madorin v. Commissioner* with strong if implicit disapproval.[138] No other court, including the Second Circuit itself and courts within the Second Circuit, has cited *Rothstein*.

4. A corollary. As a corollary to the proposal, this author believes that, without clear legislative intent or regulatory guidance, we should treat an SOGT as any other trust for any purpose other than to determine the federal income tax liabilities of the grantor and grantor's direct and indirect owners. Although the IRS has asserted that ''because [the grantor] is treated as the owner of the entire trust, [the grantor] is considered to be the owner of the trust assets *for federal income tax purposes*,''[139] the reference to ''for federal income tax purposes'' should be replaced with a more limiting reference to ''for purposes of determining the grantor's federal income tax liability.''

Both textually and doctrinally, there is no support for a more expansive view. Textually, the regulations support a disregard of an SOGT only when we are trying to determine the grantor's federal income tax attributes. So, ''if a grantor . . . is treated as the owner of an entire

[128] *Rauenhorst v. Commissioner*, 119 T.C. 157, 170-172 (2002), *Doc 2002-22803*, *2002 TNT 195-13*. (''We are not prepared to allow [the IRS's] counsel to argue . . . against the principles and public guidance articulated in [its] currently outstanding revenue rulings. . . . [W]e cannot agree that the [IRS] is not bound to follow [its] revenue rulings in Tax Court proceedings. Indeed, we have on several occasions treated revenue rulings as concessions by the [IRS] where those rulings are relevant to our disposition of the case.'')

[129] *Id.* at 171.

[130] Rev. Rul. 2004-86, 2004-2 C.B. 191 (emphasis added).

[131] Rev. Rul. 90-7, 1990-1 C.B. 153 (emphasis added).

[132] Rev. Rul. 85-13, 1985-1 C.B. 184 (emphasis added).

[133] *See supra* notes 85-89.

[134] *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).

[135] *See supra* text accompanying notes 9-12.

[136] Rev. Rul. 85-13, 1985-1 C.B. 184.

[137] ''The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust . . . the grantor has treated the trust property as though it were the grantor's property. The [IRS's] position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.'' *Id.*

[138] *Madorin v. Commissioner*, 84 T.C. 667, 676 (1985). (''We need not comment on the result reached by the Second Circuit in *Rothstein*, nor on the rationale applied by the court in reaching such result. . . . [I]t is not at all clear that the Second Circuit would apply its rationale to these facts.'') Later in the opinion, the Tax Court stated that ''in general, the grantor is treated as the owner of the partnership interest [which was the asset held by the grantor trust] for tax purposes.'' *Id.* at 680.

[139] Rev. Rul. 85-13, 1985-1 C.B. 184 (emphasis added).

trust . . . he takes into account in *computing his income tax liability* all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence.''[140] Again, ''an item of income, deduction, or credit included in *computing the taxable income and credits of a grantor* . . . under section 671 is treated as if it had been received or paid directly by the grantor . . . (whether or not an individual).''[141] Doctrinally, none of the cases or administrative pronouncements deals with federal income tax liability of a wholly unrelated third party and therefore cannot support disregarding an SOGT in such a case.

Following this corollary, interest payments made by an SOGT debtor would be sourced according to the domesticity of the SOGT, and not the residence of the grantor, because the source determination is made for determining the recipient creditor's potential federal income tax liability, and not that of the owner of the SOGT.

VI. Conclusion

In conclusion, SOGTs are much more complex to deal with than DEs in cross-border settings. Some of the complexities are historical and, in this author's view, unnecessary or even no longer supportable. For others, a more bright-line approach is both amply supported by existing IRS administrative pronouncements and would lend much welcome certainty.

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[140]Reg. section 1.671-3(a)(1) (emphasis added).
[141]Reg. section 1.671-2(c) (emphasis added).