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## New Domestic Trust Rules Apply to Qualified Plans of Foreign-Controlled Companies

In general, a qualified plan trust must be a domestic trust. The Small Business Job Protection Act of 1996 (SBJPA) changed the rules for determining whether a qualified plan's trust is a foreign or domestic trust. Just this year, the IRS published guidance for implementing these new rules.

### The Control Test

Under the new IRS rules, simple ownership of a company by a foreign entity, in and of itself, does not change the status of the trust from domestic to foreign. The key is control. A trust is a domestic trust only if, among other requirements, U.S. corporations, partnerships, citizens or residents control all substantial trust decisions. This is known as the "Control Test." Under this test, it is necessary, even in a directed trustee situation (including plans where Prudential Bank & Trust is the Trustee), to look through to whomever is directing the trustee. "Substantial trust decisions" include decisions to remove, add or replace the trustee, as well as the selection of investments being offered under the plan. Other decisions may also be considered substantial trust decisions. If a company has a foreign non-resident board of directors, or if foreign non-resident fiduciaries have the authority to make these types of decisions, the plan's qualified status could be jeopardized.

### Exemption for Trusts Established before August 20, 1996

In its published guidance, the IRS recognized that many U.S. companies today are owned or controlled by foreign entities, and that this could affect the status of qualified plan trusts. Therefore, a trust established *before August 20, 1996*, may obtain an exemption from the Control Test by filing an election signed by the plan's trustee with the plan's 1998 Form 5500 series annual report.

The final rules also contain a corrective provision if this deadline is missed. Under this provision, the plan's trustee must file a written statement with the IRS District Director having jurisdiction over the trust. This statement must include the reasons for failing to file the election in a timely manner. If the District Director determines that the failure was due to a reasonable cause, the IRS may grant the trust a filing extension. We would expect that the IRS will be liberal in granting these extensions, especially in view of the general lack of recognition of these requirements until very recently, and due to the consequences (i.e., plan disqualification) for a plan failing to have a domestic trust.

\* Republished December 2004 to reflect Prudential Retirement's acquisition of CIGNA's retirement business

### **Special Rules for Trusts Established on or after August 20, 1996**

The final rules also contain provisions for trusts created on or after August 20, 1996. Before the IRS issued these final rules, a domestic trust had to have only U.S. fiduciaries, and these fiduciaries had to administer the trust exclusively in the United States. Under the final rules, if a trust was created *on or after August 20, 1996, and before April 5, 1999*, and it satisfied the earlier IRS rules, but not the new Control Test, it can be amended to meet the new Control Test, provided this is done by December 31, 1999. In this event, the trust will be treated as meeting all of the domestic trust requirements for all taxable years.

### **No Transition Rule for Trusts Created on or after April 5, 1999**

The IRS guidance does not provide transition rules for trusts created *on or after April 5, 1999*. Any plan with a trust newly created on or after this date that does not comply with these domestic trust rules would face disqualification and would have to take advantage of the IRS Walk-In Closing Agreement Program (CAP) to preserve its qualified status.

### **Rules Do Not Address Changes to Existing Trusts**

All of these rules apply to the establishment of new trusts. They do not apply to changes made to existing trustees. However, if an inadvertent change is made to the plan's trustees, which results in the trust's conversion from a domestic trust to a foreign trust, the trustee has 12 months from the date of the inadvertent change to correct the situation. An "inadvertent change" is defined as the death, incapacity, resignation, change in residency or other change to a person who has the power to make a substantial decision regarding the trust that would cause a change of residency to the trust, but was not intended to do so. If the trustee does not correct this situation by complying with the new domestic trust rules within the 12-month period, the trust may file for an extension of time with the appropriate IRS District Director.

### **Next Steps**

If you believe your plan or trust is affected by these changes, you should discuss the matter with your legal counsel. If Prudential Bank & Trust is your plan's trustee, and you determine that you need to make an election or file documents with the IRS, Prudential Bank & Trust will execute any pre-prepared, signature ready documents that are required. Since Prudential Bank & Trust is a directed trustee, such a request must be in the form of written instructions to take a specific action.

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