

# Respect for “Form” as “Substance” in U.S. Taxation of International Trusts

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## I. RESPECT FOR "FORM"

It would be difficult to imagine how the federal tax system of the United States could function without the "substance-over-form" principle. Every analysis of the tax treatment of a transaction or transfer must, explicitly or implicitly, address the question: "Will the tax law treat this as what it appears to be?" The question of whether the tax rules will be applied according to the "form" or the "substance" of the transaction or transfer has taken on a variety of formulations in the judicial decisions.

A. *Is this in Fact a "Sham"?*

First, there is the category of cases where the taxpayer's version of events is documented but inconsistent with what actually occurred. The documents were not respected. A change in title was recorded in the name of the new owner but control over and enjoyment of the property never changed hands. Income and expense were recorded on the books of a trust but the trustee served in fact as a mere nominee. Property was leased, but only on paper. The transaction or transfer was a "fake." In effect, the form was not respected by the taxpayer.

B. *Is this a "Sham" in Substance?*

The next category of cases is much more difficult to categorize. That is unfortunate because they represent the core learning and experience in the application of "substance" over form. While there are a variety of formulations of the appropriate test in these cases, the inquiry always focuses on the lack of an economic dimension to the taxpayer's position. For example, in the leading case of *Knetsch v. United States*,<sup>1</sup> dealing with a tax shelter investment, the transaction (a leveraged investment in deferred income bonds) was treated as a "sham" because "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." On the Court's reading of the facts, the taxpayer had no credible chance for an economic profit from the investment measured on a pre-tax basis. Some of these cases blend over into the first category: the steps on which the taxpayer relies actually occurred, but the events involve other steps that limit or offset the resulting economic consequences, so that the taxpayer's change in economic position is not

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1. 34 U.S. 261, 266 (1960).

meaningful.<sup>2</sup> If a taxpayer claims that his transfer of property to a trust for the benefit of his child is not a gift but a sale, is there any difference between the case where the taxpayer never intended to collect the purchase price (a sham in fact) and the case where the taxpayer loaned the purchase money to the trust on terms that evidenced it would never be paid back (a sham in substance)?<sup>3</sup>

### C. Was this what Congress Intended?

The Court may also conclude that the actual events are outside the Congressional intent of the Internal Revenue Code (Code) provision on which the taxpayer relies. In the leading case of *Gregory v. Helvering*,<sup>4</sup> Justice Sutherland conceded that the taxpayer was legally entitled "to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits." However, he concluded that the real question was "whether what was done, apart from the tax motive, was the thing which the statute intended," and decided the case against the taxpayer.<sup>5</sup> Indeed, it should be inevitable that questions of "substance" over "form" require an analysis of statutory intent whenever the transaction or transfer is not a sham in fact (not a "fake"), and the challenge is made on the ground that the taxpayer's position has no substance apart from tax consequences. Assuming that a particular transaction or investment has some economic substance apart from tax consequences (e.g., the pre-tax profit potential is not de minimus), then it has a non-tax purpose and the question of statutory intent should become paramount. Otherwise, the substance over form doctrine would greatly circumscribe the Congressional prerogative to allow transactions to be taxed according to their form, and to encourage the form to be deliberately structured to take advantage of a tax incentive.<sup>6</sup>

More specifically, in applying "substance over form" to bona fide transactions or transfers (not a "sham" in fact), the perplexing but critical question is "how much substance is enough?" That question cannot be answered without an

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2. See Rev. Rul. 86-106, 1986-2 C.B. 28, 29 (citing and discussing the following cases: *Knetsch v. United States*, 364 U.S. 361 (1960); *Deputy v. duPont*, 308 U.S. 488 (1940); *Guaranty Trust Co. v. Commissioner*, 98 F.2d 62 (2nd Cir. 1938); *Perrett v. Commissioner*, 74 T.C. 111 (1980)).

3. See, e.g., Rev. Rul. 81-264, 1981-2 C.B. 186.

4. 293 U.S. 465, 469 (1935).

5. *Id.* at 469.

6. See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATE AND GIFTS 4-43 to 4-45 (1989); Kenneth W. Gideon, *Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters*, 5 VA. TAX. REV. 825, 847 (1986).

examination of legislative intent. The relevance of Congressional intent is obvious in “tax shelter” cases where Congress created an incentive and the taxpayer is allegedly “abusing” that privilege.<sup>7</sup> Those cases have generally concluded that, in addition to meeting the literal requirements of the statute, Congress must have assumed that the taxpayer’s activity, such as borrowing money, also had some economic purpose apart from tax consequences.<sup>8</sup> This approach actually developed initially outside of the tax shelter context. Most notably, in *Gregory v. Commissioner*,<sup>9</sup> the Tax Court began by concluding that the “meticulously drafted” statutory provision on corporate reorganizations left no room for a judicial gloss. However, the Second Circuit and the Supreme Court concluded quite the opposite: that a transaction lacking a “business purpose” could not have been intended by Congress as a “corporate reorganization.” Though the results of this analysis vary from case to case, and from opinion to opinion, the important point is that this formulation of the doctrine claims Congressional intent as its rationale. Thus, the courts should recognize that its application should adapt to the particular statutory question involved.

D. *Are We Seeing the Whole Picture*  
(the “Step Transaction” Doctrine)?

Though conceptualized as a separate doctrine, the “step transaction” doctrine largely overlaps with the “substance over form” doctrine. It might be considered, in large part, a variation on “substance over form” in that it deals with whether the form of the taxpayer’s ordering of events will be respected. Will steps be added to or subtracted from the course of events described by the taxpayer, or will the steps be reordered, to show the “true picture?” Courts have used the step transaction doctrine to link prearranged or contemplated steps, despite a party’s lack of a legal obligation or financial compulsion to complete all the steps in the transaction.<sup>10</sup> Should every step be respected, however transitory or lacking in substance? The step transaction doctrine has been employed to eliminate transitory or unnecessary steps

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7. See, e.g., *Bryant v. Commissioner*, 928 F.2d 745, 749 (6th Cir. 1991); *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985).

8. See, e.g., *ACM Partnership v. Commissioner*, T.C.M. (RIA) ¶ 97, 115, *aff’d in part and rev’d in part*, 157 F.3d 231 (3d Cir. 1998); *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

9. 27 B.T.A. 223, 225 (1932), *rev’d*, *Helvering v. Gregory*, 69 F.2d 809, 811 (2nd Cir. 1934).

10. See *King Enters. v. U.S.*, 418 F.2d 511, 516-17 (Ct. Cl. 1969).

where the steps taken were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."<sup>11</sup>

## II. "FORM" AS "SUBSTANCE"

Against this persistent belief in the sanctity of substance lies the reality that the operation of the tax law is dependent upon form. Taxpayers often choose among forms based on tax consequences, because different forms are treated differently by the tax law. Moreover, different forms are rarely completely identical in substance. Consequently, questions of degree arise in deciding whether the two forms are "similar enough" to be taxed the same way. For these reasons, form becomes substance in many cases. A Code provision contemplates a form of transaction or transfer and treats it a certain way by reason of a certain legislative policy on such matters. If a particular form then seems to vary from the norm, the question arises: "Is this what Congress intended?" A decision must be made as to whether the variance in form is material or immaterial in view of the substantive purpose. How often this question arises depends on the ingenuity of taxpayers, the context involved, and most importantly, how closely the form contemplated by the Code provision matches the legislative purpose.

### A. *Taxation of Gratuitous Transfers by Nonresidents of the United States*

The importance of form is readily illustrated in the field of U.S. taxation of international trusts and their settlors and beneficiaries. The tax rules for nonresidents of the United States depend heavily on distinctions based on form. A simple example will illustrate this reliance on form, and how form reflects substance. This example deals with transfer taxation of nonresidents. While the estate, gift and generation-skipping tax impose taxation based on legal rights to property, which are naturally matters of form, the following discussion will consider how even simple rules of form might be open to challenge in cases where another result seems to have a more substantive foundation. Even so, the simple rules of form generally prevail.

Although the U.S. estate and gift tax is imposed on gratuitous transfers by U.S. citizens and residents regardless of the location of the property, such transfers by a non-resident

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11. *Manhattan Bldg. Co. v. Commissioner*, 27 T.C. 1032, 1042 (1957).

citizen (NRA) are not subject to tax if the property is considered situated outside the United States.<sup>12</sup> Accordingly, it has become standard practice for NRAs who are purchasing U.S. situs property to effect the purchase through a non-U.S. corporation.<sup>13</sup> Is there reason to doubt the logical integrity of a system in which the U.S. estate tax applies upon the death of a non-U.S. investor to direct stockholdings in the U.S. equity market but not to the same stocks that are the sole asset of a non-U.S. company wholly owned by the same investor? It is not necessary to challenge this structure in order to defend the integrity of the system, if respect for form is an important principle that promotes consistency and ease of application both for the investor and the U.S. tax authorities.

Congress has acknowledged the viability of avoiding U.S. estate tax by the use of a non-U.S. investment company. The legislative history of the Foreign Investors Tax Act of 1966 contains this instructive passage describing the opportunity for a newly-minted NRA, having lost U.S. citizenship and residency, to avoid U.S. estate tax on U.S. situs property:

In determining the value of the gross estate of such an expatriate (as in the case of nonresident aliens generally) only property situated in the United States that was owned by him at the time of his death is included. However, the U.S. estate tax base of these expatriate decedents is expanded in certain respects to prevent him from avoiding U.S. tax on his estate by transferring assets with a U.S. situs to a foreign corporation in exchange for its stock. Such a transfer by a nonresident alien would reduce the portion of his gross estate having a U.S. situs, since the stock of a foreign corporation has a foreign situs even though the assets of the foreign corporation are situated in the United States.<sup>14</sup>

At that time, a new set of anti-avoidance rules was adopted for such expatriates, but in the process the ability of other NRAs to use the form of an investment company to avoid U.S. estate tax was expressly recognized. When these expatriation rules in section 2107 (and the parallel income tax rule in section 877) were again addressed by Congress some thirty years later, the legislative history of the Code amendments in 1996 further conceded the effectiveness of the non-U.S. corporation for investors who are not former U.S. citizens. Indeed, one of the primary changes made was to amend the income tax rules to prevent a new expatriate from transferring appreciated U.S. situs property tax-free to a controlled non-U.S. corporation because that transfer allowed the corporation

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12. See I.R.C. §§ 2103, 2511(a) (1986).

13. See WILLIAM H. NEWTON, III, *INTERNATIONAL INCOME TAX AND ESTATE PLANNING* ' 4.64 (2d ed. 1993).

14. S. REP. NO. 98-1707, at 54 (1966).

to sell the U.S. property free of U.S. tax and invest in non-U.S. property.<sup>15</sup> Thus, the expatriate could end up owning a non-U.S. corporation with non-U.S. assets, and avoid the estate tax rule enacted earlier in 1966.<sup>16</sup>

Form is also important in the application of U.S. gift taxes to NRAs. While under the situs rule, stock in a U.S. company is considered situated in the U.S., the gift tax for lifetime transfers does not apply to a transfer of intangible property by an NRA—regardless of the situs of the property gifted.<sup>17</sup> As a result, a lifetime gift by an NRA is subject to U.S. gift tax only if the subject of the gift is real property, or tangible personal property, located in the U.S. Thus, U.S. real property cannot be gifted completely free of the gift tax, but shares in a U.S. real property holding company can readily escape the gift tax, though not the estate tax. This distinction that specially protects lifetime gifts of intangibles was enacted by Congress, also in 1966, in recognition of the difficulty of enforcing a contrary result.<sup>18</sup> The point was not to encourage gifts of intangibles but rather to carve out an exception for gifts that would be too difficult for the Internal Revenue Service to find and tax in any event. Apparently, the dragnet of U.S. tax enforcement was considered formidable enough to snare stock of a U.S. company at the death of the NRA owner, but not if the NRA gifted it during life.

These rules of form are not always so benign. Certain anomalies crop up through the legislative process. Transfer taxes for an NRA, as we have seen, do not apply to lifetime gifts of stock, nor to the transfers at death of stock in a non-U.S. company. However, suppose that an NRA makes a lifetime transfer of U.S. stock into a trust with a retained interest of the kind that would subject the trust property to estate tax under sections 2036, 2037, 2038, or 2039. Suppose further that the U.S. stock is later exchanged for stock in a non-U.S. company, prior to death. In that event, the non-U.S. stock in the retained interest trust will be subject to estate tax because it is attributable to an earlier transfer to the trust of U.S. situs property, such as stock in a U.S. corporation. In other words, if property is gifted during life with a retained interest, the property is subject to estate tax if it was U.S. situs property at either the time of death or the time of the gift.<sup>19</sup> Furthermore, this

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15. See I.R.C. § 877(d)(2).

16. H.R. REP. NO. 104-496, at 148-49 (1996); STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., REPORT ON ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION 30 (June 1, 1995).

17. See I.R.C. § 2501(a)(2).

18. See S. REP. NO. 98-1707, *supra* note 14, at 57.

19. See I.R.C. § 2104(b).

statutory rule has literally no limit on the lapse of time between the initial transfer and the date of death.<sup>20</sup> This situs test seems to run counter to other principles just discussed that exempt (1) lifetime gifts of all intangibles by NRAs from U.S. gift tax, and (2) outright ownership at a NRA's death of non-U.S. situs property from the U.S. estate tax. The situs test for retained interest gifts seems logical when applied to a gift of tangible U.S. situs property such as real estate. But it is hard to rationalize why a total gift of U.S. stock is not subject to tax and total ownership at death of non-U.S. stock is not subject to tax, but an imperfect gift of U.S. stock leading to incomplete ownership at death of non-U.S. stock is then subject to tax. The anomaly originated in 1966 when the situs test for retained interest gifts by NRAs was not amended to conform with the enactment of the exemption for all gifts of intangible property regardless of situs.

Such an occasional anomaly seems to reinforce the importance of rules of form in the U.S. estate and gift tax system. These rules reflect, for example, the substantive principle that transfers at death of U.S. situs property are sufficiently connected to the United States to justify and allow, as a practical matter, the imposition of a transfer tax. This is a good example of how the rules of form embody a substantive principle—form is substance. The substantive importance of using situs as a foundation for transfer taxation was amply demonstrated by the ill-advised and unsuccessful departure from this approach in 1992 when the U.S. tax authorities initially considered applying the U.S. generation-skipping tax to transfers by NRAs of *non-U.S. situs* property in certain cases. The proposal intended to apply the generation-skipping tax to a transfer by an NRA if there were U.S. persons in each of two generations below the NRA transferor, that is, (1) a U.S. person who was a permissible beneficiary of the transferred property and (2) an ancestor of that beneficiary who was also a lineal descendant of the NRA and who thus appeared to be a “skipped” person.<sup>21</sup> This proposed regulation was severely criticized, and eventually replaced by a situs-based rule that parallels the estate and gift tax rules.<sup>22</sup> At least part of the criticism was that the rule lacked realistic boundaries for the imposition of taxation.<sup>23</sup> Since the proposal did not respect the

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20. See Tech. Adv. Mem. 9507044 (May 31, 1994) (original transfer in 1923 while U.S. citizen; death in 1991, after grantor's expatriation).

21. See Generation-Skipping Transfer Tax, 57 Fed. Reg. 61353, 61371 (1992) (to be codified at 26 C.F.R. pt. 26) (proposed Dec. 24, 1992).

22. See *id.* § 26.2663-62.

23. See, e.g., COMM. ON ESTATES AND TRUSTS, TAX SECTION, NEW YORK STATE BAR ASS'N, REPORT ON PROPOSED REGULATIONS RELATING TO THE GENERATION-SKIPPING TRANSFER TAX 41 (1993).



situs concept, it was easy to see that the proposed regulation would be very difficult to interpret and enforce, as illustrated by the following examples:

Example 1: An NRA grandfather establishes an irrevocable discretionary trust for the primary benefit of his Canadian son. As is common with British offshore trusts, the class of discretionary beneficiaries also includes the NRA's other descendants, including a U.S. daughter and her U.S. children. The Trustee has the discretion to allocate among this entire class, but is generally guided by a Letter of Wishes that requests the Trustee to provide for the Canadian son and his family, and only if none of these persons is living, then to provide for the U.S. daughter and her family. The son and daughter later die and the trust is then held under its terms for the discretionary benefit of the NRA's grandchildren, some of whom are U.S. persons. Under the proposed regulations, an interest in property would have been deemed to pass to the U.S. grandchildren, and the death of the surviving child would have been considered a taxable event as to the whole of the trust, and the generation-skipping tax would be imposed. The tax would have applied to the entire trust even if no portion of the trust is ever distributed to the U.S. grandchildren because it was exhausted by the needs of the Canadian grandchildren.

Example 2: Assume that in Example 1 above the trust did not authorize distributions to the U.S. family directly, but one more of the Canadian grandchildren had a limited power to appoint the trust among the descendants of the original transferor (other than the power holder). The generation-skipping tax would still have applied if the proposed regulations had been adopted, since the U.S. grandchildren could receive distributions pursuant to the exercise of this power.

In such a system that follows form and reflects substance, it is important to examine the form closely. This explains the result

in *Estate of Swan v. Commissioner*,<sup>24</sup> in which the court found that assets held in two Stiftungen funded by the decedent were within the decedent's gross estate under the retained interest rule discussed above. Although the taxpayer claimed the entities should be treated as non-U.S. corporations outside the scope of the U.S. situs rule, the Tax Court's findings and analysis, affirmed by the Second Circuit, concluded that the entities were much more like private trusts and that the decedent could withdraw funds from them on his sole signature. Thus, the transfer of funds to the entities was a retained interest transfer. While this appears to be a case in which "substance" triumphed over "form," that does not mean that the examination of the form is unhinged from the original forms contemplated by the statute. To say that the statute depends upon respect for the form does not mean that tax treatment turns on the mere labels applied by the taxpayer. The form must reflect substance.

The recent case of *Alumax Inc. v. Commissioner*<sup>25</sup> further illustrates the point, although it involves a domestic corporate tax issue. The question was whether a subsidiary could be properly consolidated as a member of an affiliated group under section 1504(a) on the ground that the group held "at least eighty percent of the voting power of all classes of stock" of the subsidiary. The taxpayer asserted that the eighty percent test was met because the right to elect eighty percent of the board of directors existed. However, the court found that this supermajority of the board did not have the customary powers to manage the corporation that are usually associated with that block, so the eighty percent test was not satisfied. It was more than a mechanical test, because the purpose of the voting power test was intended to allow consolidation where common management existed, not just literal voting power. The form had to be examined closely. Reliance on the labels used by the taxpayer was not enough.<sup>26</sup>

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24. 247 F.2d 144 (2d Cir. 1957).

25. 165 F.3d 822 (11th Cir. 1999), *aff'g* 109 T.C. 133 (1997).

26. The same kind of examination, and re-examination of form, applies at the legislative level. A striking example is the portfolio debt rules which allow NRAs to invest in U.S. issued debt, free of income and transfer taxes. This exemption was originally enacted in 1984 in recognition of the fact that complicated offshore debt structures and tax treaty networks could accomplish the same result. See I.R.C. § 871(h)(1); Deficit Reduction Act of 1984, Pub. L. No. 98-369, ' 127(a) 98 Stat. 494, 648-49 (1984); STAFF OF SENATE COMM. ON FIN., 98TH CONG., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMM. ON MAR. 21, 1984 416-21 (Comm. Print 1984). Later the statute was amended to prevent investments in the form of debt from enjoying this privilege if the return was contingent on the gross receipts, profits, etc., of the debtor, i.e., if the debt took on the form of equity. See I.R.C. § 871(h)(4); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, ' 13237(a)(1), 107 Stat. 312, 506-07 (1993).

## B. "Step Transactions" in International Trusts

### 1. Traditional Principles

This brings us to a further examination of the "step transaction doctrine." This doctrine cuts across the entire Code and appears to be less confined by the rigidities of form. It seems more powerful because it appears to deal most frequently with simply changing the order of the steps. Thus, it can generate different potential outcomes while still respecting the legal rights inherent in the initial structure and in the end result of a transaction or transfer.

Transfers can be characterized in several ways when the "step transaction" directive is applied to the taxation of trusts. The re-characterization issue might be considered as subparts of the ultimate question "who transferred what to where?" First of all, there are a number of examples of "shams in fact"—essentially "fake" transactions where nothing was actually transferred to a trust by legitimate documentation or the purported grantor was a mere pawn of someone else.<sup>27</sup> Secondly, there are the cases requiring closer analysis of who is the grantor. The purported grantor may not have been a mere pawn, but nevertheless was not the "true" grantor.<sup>28</sup> Thirdly, there are at least a few cases in which the property transferred was re-characterized (the "what" in the above question).<sup>29</sup> Finally, there are cases in which a gratuitous transfer to one donee (the "where" in the above question) may be re-characterized as a transfer to someone else. For example, a gratuitous transfer to a corporation is ordinarily treated as a transfer to its shareholders if the transferor and the shareholders are related parties.<sup>30</sup>

Even though the "step transaction" doctrine thus seems elastic, it still has its limits. In large part, in order to change who is the grantor or what property was transferred, the courts require the Internal Revenue Service (Service) to demonstrate that the transfer was conditional, i.e., that the "true" grantor

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27. See *Bixby v. Commissioner*, 58 T.C. 757, 779-81 (1972) (finding that trusts were mere conduits); Rev. Rul. 80-74, 1980-1 C.B. 137.

28. See *MacManus v. Commissioner*, 131 F.2d 670, 673-74 (6th Cir. 1942); *Buhl v. Kavanaugh*, 118 F.2d 315, 320-21 (6th Cir. 1941); *Estate of Denzer v. Commissioner*, 29 T.C. 237, 242-44 (1957).

29. See *Byers v. Commissioner*, 199 F.2d 273, 275-76 (8th Cir. 1952); *Estate of Levin v. Commissioner*, 90 T.C. 723, 731-32 (1988); Rev. Rul. 81-54, 1981-1 C.B. 476, 476-77.

30. See *Heringer v. Commissioner*, 235 F.2d 149, 152 (9th Cir. 1956); *Estate of Hitchon v. Commissioner*, 45 T.C. 96, 102-04 (1965); Rev. Rul. 74-329, 1974-2 C.B. 269; Rev. Rul. 71-443, 1971-2 C.B. 338.

transferred something to the nominal grantor on the condition that the nominal grantor effect another transfer. The principle that emerges from these cases is that a person must exercise “dominion and control” over the transfer in order to qualify as the grantor.<sup>31</sup> If Smith transfers to Jones on the condition that Jones transfer to the trust, then Smith is the grantor. But, if Jones is entitled to exercise dominion and control over the second transfer, then Jones is the grantor. These cases do not always require that the condition on the first transfer be legally binding, but the mere showing of proximity in time between the two transfers is not enough to show the requisite connection. Clearly, there is a willingness in some cases to re-characterize the transfer if there is an “understanding,” which in some circumstances may not be a legally enforceable condition,<sup>32</sup> but this is more than a mere expectation of what will happen next.<sup>33</sup> Most notably, in *Davies v. Commissioner*,<sup>34</sup> the Tax Court required less than a legally binding commitment but more than a mere expectation.<sup>35</sup> The court re-characterized a sale of U.S. situs property as a part gift/part sale.<sup>36</sup> The father sold the property to his son, but the father had in fact gifted the cash used by the son to pay both the initial down payment and the later installment payments on the purchase money mortgage. The court re-characterized the cash transfer used for the down payment as a transfer of real estate because it was made on the condition that it be used for that purpose, but it held that the later transfers were simply gifts of cash because there was no requirement that they be used to pay off the mortgage, just an expectation.<sup>37</sup>

## 2. Outer Limits: Situs Rules and Indirect Trust Distributions

Wherever the line is drawn between “understanding” and “wishful thinking” in such cases, there is still more expected than a proximity in time or a tracing of assets. Such more expansive

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31. See *MacManus*, 131 F.2d at 673-74; *Buhl*, 118 F.2d at 320-21; *Estate of Denzer*, 29 T.C. at 242-44; Priv. Ltr. Rul. 93-44-016 (Aug. 5, 1993).

32. See *Blake v. Commissioner*, 697 F.2d 473, 478-80 (2d Cir. 1982).

33. See *Palmer v. Commissioner*, 62 T.C. 684, 693-95 (1974), *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975) (corporation was not bound to redeem shares given to private foundation with the expectation that they would be redeemed). Cf. *LeFrak v. Commissioner*, 93 T.C.M. (RIA) 2808, 2811-13 (1993) (determining an asset's value based on property's value before a later transfer to a partnership).

34. 40 T.C. 525, 531-32 (1963).

35. See *id.*

36. See *id.*

37. See *id.*

rules have not been adopted by the courts. A rule based on proximity in time or tracing of assets can, of course, be readily adopted by Congress to address a perceived problem with a bright line test,<sup>38</sup> and this itself could be considered a use of "form" to impose tax consequences. But it is much harder to imagine such a form being adopted by a court or by regulation, unless more clearly authorized by Congress in the first instance.<sup>39</sup> The form adopted must reflect substance, and not arbitrary or broader standards for taxation than those laid down by Congress.

For example, in 1992, the proposed generation-skipping tax regulations contained a rule that would have expanded the concept of a transfer of U.S. situs property by adopting an "anti-abuse rule."<sup>40</sup> Under this proposal, all steps shortly prior to or promptly following a transfer of *non-U.S. situs* property could be aggregated to show that the effect was to transfer *U.S. situs* property, and the tax would then be applied as if U.S. situs property were transferred.<sup>41</sup> This proposal was withdrawn after it was severely criticized as inconsistent with the legislative scheme for taxing only U.S. situs property as described above.<sup>42</sup> The proposal may have grown out of frustration with the limits of the step transaction doctrine in the context of gratuitous transfers.

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38. See, for example, I.R.C. § 679(a)(5) (1998) for situations in which the grantor becomes a U.S. resident within five years of the transfer. In the partnership context, see §§ 704(c)(1)(B) and 737(b)(1).

39. Under § 707(a)(2)(B), Congress authorized the Service to re-characterize a transfer of property to a partnership and a later distribution of property or money by the partnership as a disguised sale or exchange. The regulations adopted a fairly sophisticated test of economic reality based on several specific factors and then apply a presumption of sale treatment to cases where the events occur within a two-year time frame. See Treas. Reg. § 1.707-3 (1983) *et seq.* This solution was crafted in response to a fairly contentious series of cases in which the courts had great difficulty fashioning a workable solution under the more general provision that preceded section 707(a)(2)(B). See H.R. REP. NO. 98-432, pt. 2, at 1217-21 (1984).

40. See Generation-Skipping Transfer Tax, *supra* note 21, ' 26.2663-2(d).

41. See *id.* An example of this is when an NRA first transfers U.S. real estate to a wholly-owned non-U.S. corporation and then transfers the stock.

42. In commenting on an example like that in the prior footnote, one article concluded:

It is well known that the situs rules can be circumvented by such a transfer to a corporation and, if it is the government's objective to close this gap in the situs rules, it should not do so merely for GSTT purposes. Further, it should seek to do so by encouraging a legislative change, not through a regulation.

Richard L. Doernberg & Jeffrey W. Pennell, *Application of the Generation-Skipping Transfer Tax in an International Setting*, 6 TAX NOTES INT'L 723, 727 (Mar. 22, 1993).

As compared to business transactions, these transfers are more readily directed by a single party, the donor. As a result, the most desirable form of a transaction can be more easily structured in advance without the need for the kind of “prior understandings” with other parties that can trigger the application of the step transaction doctrine. Nevertheless, the proposed regulation clearly overstepped its statutory boundaries and would have created a startling exception to the established principle of limiting taxation to U.S. situs assets.

Similarly, the proposed regulations under section 643(h) go beyond traditional principles.<sup>43</sup> That section provides that “any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be deemed . . . to have been directly paid by the foreign trust to such United States person.”<sup>44</sup> Under proposed regulation 1.643(h)-1, any indirect payments made through a “tainted” intermediary will be “deemed” direct distributions from the trust to the beneficiary.<sup>45</sup> The proposed regulation sets forth three tests to determine when we have a tainted intermediary: the “tracing” test, the “but for” test, and the “preconceived plan” test. Under the “tracing” test, an intermediary is tainted if the intermediary is related to the trust or the beneficiary and the property received by the beneficiary can be traced to the trust.<sup>46</sup>

43. See Prop. Treas. Reg. § 1.643(h)-1, 62 Fed. Reg. 30790 (June 5, 1997).

44. I.R.C. § 643(h) (1998).

45. Proposed regulation section 1.643(h)-1 provides:

(a) *In general.* For purposes of sections 641 through 683, any amount of property that is derived, directly or indirectly, by a United States person from a foreign trust through another person (an intermediary) shall be deemed to have been paid directly by the foreign trust to the United States person if any one of the following conditions is satisfied—

(1) The intermediary is related (within the meaning of paragraph (e) of this section) to either the United States person or the foreign trust and the intermediary transfers to the United States person either property that the intermediary received from the foreign trust or proceeds from the property that the intermediary received from the foreign trust;

(2) The intermediary would not have transferred the property to the United States person (or would not have transferred the property to the United States person on substantially the same terms) but for the fact that the intermediary received property from the foreign trust; or

(3) The intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax.

(b) *Exception for grantor as intermediary.* Paragraph (a) of this section shall not apply if the intermediary is the grantor of the portion of the trust from which the amount is derived.

Prop. Treas. Reg. § 1.643(h)-1, 62 Fed. Reg. 30790 (June 5, 1997). For the definition of grantor, see *id.* § 1.671-2(e).

46. See *id.* § 1.643(h)-1(a)(1).

Under the "but for" test, an intermediary is tainted if the intermediary would *not* have transferred the property to the U.S. person *but for* the fact that the intermediary received property from the trust.<sup>47</sup> Under the "preconceived plan" test, an intermediary is tainted if the intermediary received property from the trust pursuant to a plan to avoid U.S. taxes.<sup>48</sup>

Through the proposed regulation, the Service treats a "tainted" intermediary as a nominee while attributing true ownership of the property to the trust. Since a nominal owner is disregarded for tax purposes, this allows the Service to disregard what purports to be the form of the transaction and to treat the distribution as a distribution from the trust to the beneficiary. The broad language used in the statute and proposed regulation raises the question of whether the Service can treat an intermediary as a nominee when that intermediary would be recognized as a true owner under existing common law and judicial doctrines. The distinction between nominal ownership and beneficial ownership pervades the tax law, and a substantial body of common law exists to distinguish between the two. Did Congress intend to embody these common law principles of ownership when it enacted section 643(h), or did Congress instead authorize the Service to disregard a form that has a substantive basis in common law?

Since Congress did not expressly affirm or deny common law principles when it enacted this new Code provision, it should be interpreted under the general rule that federal courts will interpret federal statutes consistent with existing law, which includes common law principles.<sup>49</sup> The concept of nominal ownership versus true ownership is implicit in Congress' use of the word "indirectly" in section 643(h).<sup>50</sup> The term "indirectly" has been interpreted to mean "not leading to aim or result by the plainest course or method or obvious means."<sup>51</sup> Interpreting Congress' use of the word "indirectly" in section 643(h) in conjunction with common law suggests that Congress intended to embrace common law doctrines that disregard, for tax purposes, only nominal owners of property.

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47. See *id.* § 1.643(h)-1(a)(2).

48. See *id.* § 1.643(h)-1(a)(3).

49. See *Isbrandtsen Co. v. Johnson*, 343 U.S. 779, 783 (1952).

50. See also Treas. Reg. § 1.509(a)-3(j)(2), (3) ex.3 (1992) (illustrating "indirect contribution" via a public charity).

51. *Cahen Trust v. United States*, 292 F.2d. 33, 36 (7th Cir. 1961) (interpreting the phrase "paid . . . indirectly by the decedent").

The legislative history that accompanied the enactment of section 643(h) supports this interpretation. Section 643(h) replaced section 665(c)<sup>52</sup> which provided:

(c) SPECIAL RULE APPLICABLE TO DISTRIBUTIONS BY CERTAIN FOREIGN TRUSTS—For purposes of this subpart, any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust.

The House Committee Report that accompanied the enactment of section 643(h) and the repeal of section 665(c) provided:

DISTRIBUTIONS BY FOREIGN TRUSTS THROUGH NOMINEES.—The bill generally treats any amount paid to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust, as if paid by the foreign trust directly to the U.S. person. This rule disregards the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike present law, however, the rule applies whether or not the trust was created by a U.S. person. The rule does not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.<sup>53</sup>

In addition to the legislative history, the General Explanation by the Joint Committee provided similar language.<sup>54</sup> Thus, we look to existing common law and judicial doctrines to determine whether the form, disregarded by Service, reflects the substance (i.e., when an apparent owner will be treated as a nominee).<sup>55</sup>

The owner of property for federal tax purposes is determined from all the facts and circumstances.<sup>56</sup> Courts look to beneficial ownership, as opposed to mere legal title, to identify the owner of property.<sup>57</sup> The hallmarks of beneficial enjoyment include command over the property or the enjoyment of its economic

52. I.R.C. § 665(c), *repealed by* the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1904(c)(2), 110 Stat. 1755, 1912.

53. H.R. REP. NO. 104-542 (II), pt. 2, at 79, *available in* 1996 WL 226929.

54. *See* STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS 268, 271 (J. Comm. Print 1996).

55. A similar analysis should apply under § 672(f)(5) addressing so-called “give and go” arrangements. *See* I.R.C. § 672(f)(5) (Supp. II 1996) (amending I.R.C. § 672(f) (1994)). Note, however, that section 672(f)(5) is a much more circumscribed rule and will actually apply in a larger percentage of cases in which it presumptively applies. *Id.*

56. *See* *Hang v. Commissioner*, 95 T.C. 74, 80 (1990) (citing *Schoenberg v. Commissioner*, 302 F.2d 416, 419 (8th Cir. 1962) (beneficial owners of stock subject to tax on corporate distributions)).

57. *See* *Serianni v. Commissioner*, 80 T.C. 1090, 1104 (1983), *aff'd*, 765 F.2d 1051 (11th Cir. 1985) (finding that beneficial owner, rather than nominal owner, of a certificate of deposit was liable for tax).



benefits.<sup>58</sup> When beneficial ownership does not coincide with nominal ownership, courts have used the step transaction doctrine and substance-over-form principle to disregard the nominal owner for tax purposes. For example, in *Heyen v. United States*<sup>59</sup> the Tenth Circuit Court of Appeals used the substance-over-form principle to disregard transfers to intermediaries. The court concluded:

The evidence at trial indicated decedent intended to transfer the stock to her family rather than to the intermediate recipients. The intermediary recipients only received the stock certificates and signed them in blank so that the stock could be reissued to a member of decedent's family. Decedent merely used those recipients to create gift tax exclusions to avoid paying gift tax on indirect gifts to the actual family member beneficiaries.

Courts have disregarded the form of the transaction in other contexts as well.<sup>60</sup> These common law and judicial doctrines should be used to decide whether the application of proposed regulation section 1.643(h)-1(a) in a specific circumstance is valid.<sup>61</sup>

Thus, the proposed regulation should be valid only to the extent that it is applied by the Service within these existing common law and judicial doctrines. Generally speaking, the third test under the proposed regulation, the "preconceived plan," is likely to be sustained since it is arguably nothing more than a restatement of the step transaction doctrine. However, the second test is more troublesome. Whether a particular application of the proposed regulation goes beyond existing law must be determined on a case-by-case basis. The "but for" test can be properly

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58. See *Buhl v. Kavanaugh*, 118 F.2d 315, 320 (6th Cir. 1941); *Hang*, 95 T.C. at 80 (1990) (quoting *Anderson v. Commissioner*, 164 F.2d 870, 873 (7th Cir. 1947)).

59. 945 F.2d 359, 363 (10th Cir. 1991).

60. See *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969) (holding that the value of reciprocal trust established by spouse is included in decedent's gross estate); *Schultz v. United States*, 493 F.2d 1225, 1226 (4th Cir. 1974) (holding that the gifts to children of reciprocal donors treated as gifts to children of donor); *Johnson v. Commissioner*, 86 F.2d 710, 712 (2d Cir. 1936) (noting that the question in such circumstances is "whether the transaction . . . is in reality what it appears to be in form" and rejecting intermediary "gift" as sham); *Bixby v. Commissioner*, 58 T.C. 757, 791 (1972) (disregarding nominal grantor).

61. Courts have traditionally shown the greatest amount of deference to a legislative regulation. See *Rowan Cos. v. United States*, 452 U.S. 247, 252 (1981). The most recent formulation of the standard of review is the reasonableness standard articulated in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844, 866 (1978) and its progeny. See *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 983 (7th Cir. 1998); *Estate of Millikin v. Commissioner*, 125 F.3d 339, 343 (1997). A regulation may be unreasonable and held invalid where the regulation attempts to tax income that would otherwise not be taxed. See *Weidenhoff, Inc. v. Commissioner*, 32 T.C. 1222, 1242 (1959).

applied to disregard a disinterested intermediary such as a corporate trustee. Funds are not taxable to an entity that acts merely as a custodian.<sup>62</sup> Factors that may indicate that an intermediary is serving as a mere conduit or as a repository of funds include lack of discretion over the use of the funds, no independent reason for receiving the funds transferred from a foreign trust, and the entity is not related to the grantor or beneficiary.<sup>63</sup> However, the “but for” test must require in other cases some showing of intent, i.e., some evidence of prearrangement. To take a simple case, it would be a substantial extension of the law to treat an impecunious NRA as a mere “intermediary” on the ground that he was able to make a gift to his deserving U.S. nephew only because the NRA received a distribution from a non-U.S. trust that made him rich. While these facts would literally meet the “but for” test in the proposed regulations, they could not have been intended to be within the scope of the statute. A simplification may be to eliminate the “but for” test as a separate test and incorporate it into the “preconceived plan” test. This would not narrow the scope of regulation since those cases within the scope of the “but for” test would likely come within the “preconceived plan” test as well.

The “tracing test” is the most troubling of the three tests for a tainted intermediary. For example, if mother receives a French Chateau from foreign trust and then twenty-five years later leaves the Chateau to son upon her death, mother is a tainted intermediary under the tracing test and son is to be treated as if he received a direct distribution from the trust. A literal application of the proposed regulation dictates this absurd result. In these circumstances, the son would have a strong argument that mother’s ownership of the property eliminates any nexus between the trust and the property. As noted earlier, the mother’s “dominion and control” over the property is enough to dispel the notion that this is a “step transaction” under existing law.

There will be many other circumstances where the “tracing test” can be applied to disregard related intermediaries that act as nominees. In the example above, if mother owned the French Chateau for twenty-four hours prior to the transfer to son, then the transfer to son likely would be deemed a direct transfer from the trust to son under the proposed regulation. This application

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62. See, e.g., *Illinois Power Co. v. Commissioner*, 792 F.2d 683, 689 (7th Cir. 1986) (public utility did not recognize income when it held receipts as “custodian”).

63. For a discussion of relevant factors, see COMM. ON ESTATES AND TRUSTS, TAX SECTION, NEW YORK STATE BAR ASS’N, COMMENTS ON NEW PROPOSED REGULATIONS UNDER SECTIONS 643(a), 671 AND 672(f) OF THE INTERNAL REVENUE CODE 4-6, Dec. 4, 1997, available in LEXIS, Fedtax Library, TNT File.

of the proposed regulation should be upheld if mother serves as a mere nominee.

No doubt some taxpayers will attempt to avoid the reach of section 643(h) altogether by using the grantor as the intermediary between the foreign trust and the beneficiary. Under the language of the statute, the payment will not be *deemed* to have been directly paid by the foreign trust to the U.S. person if the grantor is the payor. Yet, the Service should also be free to show that the grantor is a mere nominee under the analysis discussed above. If the common law and judicial doctrines suggest that the grantor is merely a nominal payor of money or property earlier distributed from the trust, then the beneficiary should be treated as receiving a distribution from the trust.

In this kind of analysis, the review of common law and judicial doctrines is not merely an academic exercise. The common law provides the substance by which the form is examined, but the form is the first point of departure in the analysis. If and when the form no longer reflects the substance, the courts generally will follow the substance. However, this is not a license to disregard the form of a transaction simply because the statutory scheme has proven by experience to be ineffective or incomplete. Indeed, there may be cases in which no legislative purpose is apparent for requiring a particular form. The next step is not to effectively rewrite the statute but rather to conclude that the literal form alone is controlling. For example, in *Helvering. v. Southwest Consolidated Corp.*, the Court concluded that the requirement under section 368(b)(1)(B) of an exchange "solely" for voting stock left "no leeway" so that adding any other consideration in the exchange, however modest, violated the statutory requirement.<sup>64</sup>

Having illustrated how the U.S. tax system relies on form, and respects form as a reflection of substance, this Article will now examine how this principle can be further applied to the income taxation of non-U.S. trusts, and in particular, to trusts holding investment companies.

### III. TRUSTS HOLDING INVESTMENT COMPANIES

#### A. *Taxation of Trusts*

A non-grantor trust that is not resident in the United States for income tax purposes (a "foreign trust") is nevertheless

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64. 315 U.S. 194, 198 (1942).

governed by the same basic “distributable net income” (DNI) regime as domestic trusts when it makes a distribution. The trust will be regarded for federal income tax purposes as a mere “conduit,” to the extent the foreign trust distributes (or is deemed to distribute) only amounts attributable to its DNI for the current tax year.<sup>65</sup> The tax treatment therefore will “flow through” to the beneficiaries, and the beneficiary will be taxed in roughly the same manner as if he had earned that “distributed” income directly.<sup>66</sup> This is the “traditional” rule for DNI, as defined in section 643, which is roughly equivalent to the trust’s net ordinary income, capital gains if currently paid or payable, and other taxable income, as determined under U.S. income tax principles.

There are, however, a number of special rules that apply to distributions by a *foreign* non-grantor trust to a U.S. beneficiary if the trust has accumulated income. These rules basically levy an income tax at ordinary income tax rates, plus an interest charge on this tax that was previously deferred, to the extent there is an “accumulation distribution.” An “accumulation distribution” will occur whenever two conditions are satisfied: (a) distributions for the year exceed the current year’s income (as measured for both income tax purposes and accounting purposes), and (b) there is undistributed net income (UNI) in the trust from prior years, *including undistributed capital gains*.<sup>67</sup> This is the same principle that applied to U.S. trusts prior to the repeal in 1997 of the “throwback rule” for most domestic trusts.<sup>68</sup>

An accumulation distribution from a foreign trust can have serious adverse tax implications to a U.S. beneficiary. Since the foreign trust is not taxed currently by the United States on its net worldwide income (section 641(b)), the Code provides that U.S. beneficiaries will be taxed upon later accumulation distributions on a worldwide basis. Furthermore, a distribution of more than the current year’s income is almost certain to include an accumulation distribution because in calculating UNI, “income” includes foreign-source income even though such income is not taxable to the trust because it is not resident in the United

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65. See I.R.C. § 651(b) (1994) (limiting deduction to amount of DNI for the taxable year).

66. *Id.* § 652 (requiring that the amount of income for the taxable year that is required to be distributed by a trust under section 651 shall “be included in the gross income of the beneficiaries to whom the income is required to be distributed”).

67. *Id.* §§ 643(b) (defining “income” for the subpart), 665(b) (defining “accumulation distribution”), 666(a).

68. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 507(a)(1) 111 Stat. 856 (amending section 665 by inserting a new subsection (c)).

States.<sup>69</sup> Capital gains also are taxed adversely when accumulated and later distributed from the foreign trusts. They are added to UNI in foreign trusts, and the substantially lower effective U.S. income tax rate on long-term capital gains (20 percent) as compared to ordinary income (e.g., 39.6 percent) is lost because such accumulation distributions from a foreign trust are all taxed as ordinary income.<sup>70</sup> Finally, the trust may have expenses that are not deductible against income under U.S. tax law (e.g., expenses of maintaining a personal residence). Thus, income that is not taxable to the foreign trust, but that is taxable to the U.S. beneficiaries and not used for expenses that are *deductible* to the trust, will be considered UNI for this purpose.

Prior to 1996, an accumulation distribution was taxed at the U.S. beneficiaries' average marginal tax rate for the prior five years, plus interest.<sup>71</sup> Interest was computed at a fixed annual rate of six percent, with no compounding.<sup>72</sup> When an accumulation distribution involved amounts accumulated in more than one year, the deferral period for the six percent charge was the average number of years of deferral, but the average was not weighted to take into account the amount of the distribution from each year.<sup>73</sup> As a result, the effective interest charge could be manipulated by creating small accumulations in a year shortly before a distribution to offset very large accumulations dating back several years. The ability to manipulate the interest charge ended in 1996.

In 1996, Congress provided for a nondeductible *compound* interest charge applied to the amount of tax that was effectively deferred during the time that the beneficiary receiving the distribution was a U.S. person (regardless of the beneficiary's age). The interest rate is six percent per year for distributions from accumulations attributed to the period prior to 1996, and that rate is applied on a compound basis as of January 1, 1996. For income earned and accumulated thereafter, the varying rate for tax underpayments applies.<sup>74</sup>

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69. See I.R.C. § 643(a)(6).

70. See *id.* §§ 643(a)(6), 667(e).

71. See *id.* §§ 666, 667(a) (referring to § 668 for the amount of interest).

72. See *id.* § 668(a), prior to its amendment in the Small Business Job Protection Act of 1996, Pub. L. No. 104-88, ' 1906(a), 110 Stat. 1755, 1914.

73. See *id.*

74. See *id.* §§ 665(b) (defining "accumulation distribution"), 667(a)(3), 668, 6621(a)(2) (explaining that the determination of interest rates is the rate applicable to underpayments of tax).

### B. *Taxation of Foreign Investment Companies*

Several special U.S. tax provisions address ownership in non-U.S. corporations by U.S. persons, particularly investment companies or companies in a tax haven. Since the U.S. generally does not tax non-U.S. corporations on foreign-source income, these special U.S. tax rules are designed to prevent U.S. persons from using non-U.S. corporations to avoid tax by accumulating income offshore. These rules are principally, though not entirely, directed at the passive investment assets of non-U.S. corporations that are controlled by U.S. persons. The impact of these rules can be particularly disruptive if, for example, a non-U.S. trust in a tax haven jurisdiction owns one or more such passive investment corporations, and the trust has one or more U.S. beneficiaries governed by these rules.

The controlled foreign corporation (CFC) rules require closely held U.S. ownership of the stock, but include corporations with a much wider variety of assets and activities than the foreign personal holding company (FPHC) rules. In broad outline, a foreign corporation is a CFC if more than fifty percent of its stock, by value or vote, is owned directly or indirectly by U.S. shareholders who, for CFC purposes, hold ten percent or more of the company's stock by vote.<sup>75</sup> Such a U.S. shareholder of a CFC must include in his own income the pro rata share of the CFC's income, including "Subpart F income" (which in turn includes FPHC income with certain modifications, and sales and services income derived from transactions with related parties) and certain other items, (such as any increase in the company's earnings invested in U.S. property).<sup>76</sup> Such U.S. shareholders are generally not simultaneously subject to the passive foreign investment company rules on the same stock.<sup>77</sup>

Under the FPHC rules, an individual who becomes a U.S. resident and continues to own stock in a FPHC will be taxed as if a dividend equal to his pro rata share of undistributed FPHC income had been paid to him. For this purpose, FPHC income is essentially undistributed income, and income that is paid to a foreign intermediary such as a foreign non-grantor trust.<sup>78</sup> Losses are not similarly passed out to the shareholder, so there is no netting of entity level results if the U.S. shareholder owns

75. See generally *id.* § 957 (delineating what constitutes a CFC).

76. See *id.* § 951 (Supp. II 1996).

77. See *id.* § 1296, amended by ' 1121 of Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

78. See *id.* § 551(a), (f). In addition, a gain on the disposition of shares by U.S. shareholders is taxed as a dividend rather than as capital gain. See I.R.C. § 1248(a) (Supp. II 1996).

stock in more than one FPHC. An FPHC generally means a foreign corporation (i.e., non-U.S.) in which more than fifty percent of the stock, by value or vote, is owned by five or fewer U.S. citizens or residents, after applying attribution rules, and whose income is at least sixty percent attributable to interest, dividends, rents, royalties, stock or securities gains, and similar passive income (reduced to fifty percent once the corporation becomes a FPHC).<sup>79</sup>

Prior to the Deficit Reduction Act of 1984 (DEFRA 1984), it was possible to take the position that FPHC treatment did not apply if the shareholder of the investment company was a non-U.S. trust, even if the trust had U.S. beneficiaries. The U.S. taxpayer, as beneficiary of the trust, arguably would be insulated from current taxation under the FPHC rules.<sup>80</sup> In DEFRA 1984, Congress eliminated this result when it passed a rule that attributed stock of a foreign investment company owned by a foreign trust directly to the beneficiaries of the trust.<sup>81</sup> Shortly thereafter Congress further clarified the law by dealing with dividends paid by the investment company to the trust. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA 1988) provided that *distributions* to an intervening foreign trust owning stock in the FPHC would be treated as distributions to the trust's beneficiaries.<sup>82</sup>

In this same time frame, Congress also addressed the broader issue of investments by U.S. taxpayers in a foreign investment company with fifty percent or less U.S. ownership. Investments in offshore mutual funds had been actively marketed in the U.S. as a tax-deferred investment since the FPHC and CFC rules did not apply due to the lack of control by U.S. persons. This changed with the passage of the passive foreign investment company (PFIC) rules in the Tax Reform Act of 1986. A PFIC is characterized by a passive income/assets test (very differently defined than in the FPHC rules), but the stock ownership can be *closely or widely held* and the percentage of U.S. ownership is irrelevant. Unlike the FPHC, there is no automatic "deemed distribution," but a U.S. shareholder of a PFIC, such as a foreign mutual fund, must now choose among unappealing alternatives: (i) current inclusion in income of the U.S. shareholder's pro rata share of current ordinary income and capital gains of the PFIC pursuant to a shareholder election (a so-called "qualified electing fund" or "QEF" election),<sup>83</sup> (ii) a new "mark-to-

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79. See *id.* § 552.

80. See H.R. REP. NO. 98-432, pt. 2, at 1535 (1984).

81. See Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 666.

82. See S. REP. NO. 100-445, at 329-30 (1988); see also H.R. REP. NO. 99-426, at 932 (1985).

83. See I.R.C. § 1295 (1994).

market" election for marketable PFIC securities where gain is taxed annually at ordinary income rates,<sup>84</sup> or (iii) upon a sale of the PFIC stock (or certain special distributions to the shareholders), the imposition of ordinary income tax treatment and an interest charge.<sup>85</sup> Importantly, the interest charge is calculated on certain assumptions that are purportedly designed to estimate the deferral of U.S. tax on undistributed gains and income but seem instead to assume the greatest possible deferral and corresponding interest charge by treating the gain as earned equally over the deferral period.

#### IV. ATTRIBUTION OF INVESTMENT COMPANY STOCK TO U.S. BENEFICIARIES

In each of these offshore investment company provisions, Congress addressed ownership by foreign trusts. The FPHC, CFC, and PFIC rules all attribute stock owned by a trust to the beneficial owners of the trust. When such an investment company is held by a non-U.S., non-grantor trust, the rule makes the trust transparent, so that income is includable and taxable to the U.S. beneficiary as if the stock were owned directly.<sup>86</sup> This is very problematic. For example, distributions from the trust may be needed by the U.S. beneficiary to pay the resulting taxes. These tax payments to the U.S. Government, and related reporting of information on the trust and the underlying corporation, can be disruptive to the confidentiality concerns of other branches of the family who may not have any similar obligation. Also, even if no distributions are required, a detailed information return may still be required by these foreign corporation rules. Yet, this rule clearly applies even if no U.S. resident ever personally made a transfer to the trust, and if taken literally, it applies to a U.S. beneficiary who has no clearly-enforceable right to trust distributions.

##### A. Attribution for Testing Status, and Including Income

The context of this trust attribution to beneficiaries is a very comprehensive statutory scheme. The CFC and FPHC rules have broad and detailed provisions attributing ownership among family members and to and from entities (trusts, corporations, partnerships) in order to test for CFC or FPHC status. Attribution for income inclusion purposes is much more limited,

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84. See *id.* § 1296, amended by ' 1122 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

85. See I.R.C. § 1291.

86. See *id.* §§ 551(f), 958(a)(2), 1298(b)(5); Treas. Reg. ' 1.951-1 (as amended in 1983).



but ownership by foreign entities generally cannot be used to shield the U.S. shareholder from having to include FPHC or CFC income in his personal income tax obligation. As indicated below, if a trust owns the shares, the Code provides that this ownership can be attributed to U.S. beneficiaries for all purposes.

Unlike the CFC rules regarding family attribution and attribution to entities under section 958(b), the FPHC rules will actually attribute the share ownership of a *non-U.S.* shareholder to a *U.S.* shareholder in determining whether the company meets the closely held U.S. ownership test. The only limit is that stock owned by an NRA is still not attributed to a U.S. family member (other than a spouse) who does not otherwise own any stock at all, in fact or through non-family attribution.<sup>87</sup>

Because closely held ownership or U.S. control is irrelevant for defining a PFIC, attribution of ownership is generally not as important. However, the PFIC attribution rules<sup>88</sup> do attribute ownership of PFIC stock held by an entity to the owner of the entity, proportionately, through multiple tiers, in order to impute ownership to a U.S. person for purposes of applying the alternative taxing regimes.<sup>89</sup>

As applied to shares held by a foreign non-grantor trust, the PFIC attribution rules and related provisions in section 1298 can be inexplicably harsh. The PFIC regime ordinarily does not cause phantom income in the absence of a cashless disposition of stock.<sup>90</sup> There is no automatic deemed distribution to the shareholder, which is consistent with the concept that closely held ownership or U.S. control is irrelevant for defining a PFIC. However, a U.S. beneficiary could be attributed ownership of the PFIC stock owned by a foreign trust, and can then be attributed phantom income when the PFIC pays a dividend *to the trust* if section 1298(b)(5) is applied literally. The beneficiary could be charged with income as if the beneficiary had actually received from the PFIC the portion of the dividend attributed to the beneficiary from the trust, even though the beneficiary may not actually be receiving any comparable distributions from the trust. The result is quite different than the treatment of a U.S. beneficiary whose beneficial interest in a foreign non-grantor

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87. See I.R.C. § 554(c) (1994).

88. See *id.* § 1298.

89. In addition, when the PFIC rules measure the critical time period for computing the tax deferral and the related interest charge, sections 1291(a)(3) and 1223(2) provide for "tacking" if the transferor passed on a carry-over basis. Thus, a transfer by gift (or bequest, section 1291(e)) from one generation to the next will not purge the taint of the deferred tax and accumulating interest charge due on sale by an ultimate U.S. resident or citizen owner.

90. Prop. Reg. 1.1291-3(b).

trust is swelling with income accumulated from other sources (e.g., not investment companies, but, say, investment partnerships). This result is also quite different from the treatment of an outright U.S. owner of PFIC shares. These persons are generally free of U.S. tax liability on the income until it is received.

### B. Allocation to Beneficiaries

Despite the fact that trust attribution to beneficiaries has been part of the Code now for over ten years, the application of the rule remains unclear. In each part of the FPHC, CFC, and PFIC regime, the statute calls for the stock to be attributed "proportionately" to the beneficiaries. This begs the obvious question: in proportion to what? Regulatory guidance has been long delayed. Sometimes the existing regulations refer again to attributing ownership to the beneficiaries "proportionately," without defining the term.<sup>91</sup>

The most difficult issue is determining whether a U.S. beneficiary of a foreign non-grantor trust will be subject to current taxation on "phantom" income under the FPHC, PFIC, or CFC antideferral regimes. The issue is made especially difficult because, as indicated above, there is a risk that taxable income may be allocated to trust beneficiaries who are not receiving it currently and may *never* receive it, especially in view of the fact that beneficial interests in the customary offshore trust are largely indeterminate, since the trust language usually follows the British tradition of granting enormous discretion to the trustee over distributions.

The answer depends on the method of stock attribution under those sections. Arguably, one of three stock attribution methods will be used to attribute stock of a foreign corporation owned by a foreign trust to the trust beneficiaries: (1) actuarial, (2) pure current distributions, or (3) facts and circumstances.

#### 1. Actuarial

Stock held in a non-grantor trust may be allocated to beneficiaries in proportion to the beneficiaries' actuarial interest in the trust. Under both the foreign and domestic personal holding company rules, stock owned by a trust is considered as

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91. See Treas. Reg. ' 1.958-1(c)(2) (as amended in 1983); Treas. Reg. § 1.958-2(c)(1)(ii)(a); see also Rev. Rul. 90-106, 1990-2 C.B. 162 (grantor trust); Prop. Treas. Reg. 1.1291-1(b)(8) pmb. of Apr. 1, 1992 (suggestion to define "proportionate" for PFIC purposes by reference to the attribution rules in Treas. Reg. ' 25.2701-6 concerning estate freezes).

owned proportionately by its beneficiaries.<sup>92</sup> The Service has concluded that the term beneficiary, under section 544 of the *domestic* personal holding company rules, has the same meaning as in section 318.<sup>93</sup> Under section 318, stock is attributed to trust beneficiaries in proportion to their actuarial interest in the trust.<sup>94</sup> The actuarial method, however, has not been used to allocate stock from a trust in which the beneficiaries have a discretionary interest rather than a specifically definable interest. Under these circumstances, the Service has either allocated in proportion to current distributions or under a facts and circumstances test.

## 2. Pure Current Distributions

Stock held in a foreign trust also may be allocated in proportion to current distributions from the trust. In *Stueben Securities Corp. v. Commissioner*, the taxpayer attempted to avoid the domestic personal holding company rules through the use of trusts with present and future interests such that no five or fewer individuals owned more than fifty percent of the outstanding shares.<sup>95</sup> The Tax Court concluded that beneficiaries for purposes of the domestic holding company provision "means those who have a direct present interest in the shares and income in the taxable year and not those whose interest, whether vested or contingent, will or may become effective at a later time."<sup>96</sup> Thus, the court refused to take an actuarial approach even where the future interest was vested and was subject to actuarial valuation. Although no other courts have applied the "pure" present interest test used by the Tax Court in *Stueben*, the facts and circumstances test sometimes leads to the same result.

## 3. Facts and Circumstances

Stock held in a foreign trust may be allocated to the trust beneficiaries using a facts and circumstances test. Under this test, relevant factors would include any pattern of past distributions, appropriate mortality assumptions, the trustee's fiduciary duties, and the relationships among the trustee and the

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92. See I.R.C. §§ 544(a)(1), 554(a)(1) (1994).

93. See Rev. Rul. 71-353, 1971-2 C.B. 243.

94. See I.R.C. § 318(a)(2)(B); see also Rev. Rul. 62-155, 1962-2 C.B. 132 (stock attributed to beneficiaries in proportion to actuarial interest); *Phinney v. Tuboscope Co.*, 268 F.2d 233 (1959) (children were beneficiaries even though Trustee could postpone all distributions until child reached age 21).

95. See 1 T.C. 395, 399 (1943).

96. *Id.*

beneficiaries.<sup>97</sup> In Private Letter Ruling 90-24-076, the Service addressed the issue of how to determine a beneficiary's actuarial interest in an irrevocable trust, for purposes of section 542(a), the personal holding company provision, where the trustees had the complete discretion to distribute income and principal from the trust.<sup>98</sup> The Service determined that stock owned by the trust should be attributed to the trust beneficiaries based on the pattern of actual distributions from the trust.

Because in that ruling the trustees had unrestricted discretion in selecting the recipients of the income and principal, the trust's beneficiaries did not have an actuarial interest in the trust that could be computed pursuant to the guidelines contained in Revenue Ruling 62-155<sup>99</sup> and Treasury Regulation section 1.318-3(b).<sup>100</sup> As a result, the Service relied upon a "facts and circumstances" method of attributing ownership of the trust's stock to the beneficiaries and examined the "pattern of past distributions" from the trust. The pattern of distributions from the trust indicated that three of settlor's children (and their respective lineal descendants) had been receiving one hundred percent of the trust's income. The Service concluded that "[e]ach beneficiary receiving distributions under the pattern will be considered to own an income interest in the trust in the same proportion that the amount of distributions he receives bears to the total amount of the distributions."<sup>101</sup>

#### 4. Uncertain Results

A simple example illustrates the difficulty in applying this authority to foreign trusts that own a foreign investment company. Assume that a U.S. taxpayer is the income beneficiary of foreign trust, and the remainder passes to an NRA in ten years. Furthermore, assume for simplicity that the NRA is unrelated to the U.S. taxpayer (e.g., the NRA is a charity). The income beneficiary is to receive the first \$100,000 of the trust's income, and the additional income must be accumulated. Now, what if the investment company earns \$2 million of income per year? Is the investment company an FPHC? Should the answer change if the investment company earns \$200,000 of income per year? In the first scenario, the value of the remainder exceeds the value of

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97. See Priv. Ltr. Rul. 90-24-076 (Mar. 21, 1990); Priv. Ltr. Rul. 87-48-043 (Sept. 1, 1987).

98. See Priv. Ltr. Rul. 90-24-076, *supra* note 97.

99. Rev. Rul. 62-155, 1962-2 C.B. 132.

100. Treas. Reg. § 1.318-3(b).

101. Priv. Ltr. Rul. 90-24-076, *supra* note 97.

the income interest; yet, it is unclear how this affects attribution of the stock.

Under the actuarial method of allocation, the investment company is not an FPHC if the investment company earns \$2 million of income, since the majority of the stock would be attributed to the NRA remainderman. Thus, the U.S. beneficiary would be subject to the PFIC rules but not the FPHC rules.

Under the pure current distribution method of allocation, the investment company is an FPHC under both the \$2 million and the \$200,000 scenarios, since all the current distributions are to the U.S. person. Thus, the U.S. beneficiary would be subject to current taxation on \$100,000 under the FPHC regime.

Next, consider the same trust with an unrelated NRA income beneficiary and a U.S. remainderman. Under the actuarial method, the investment company is an FPHC if the investment company earns \$2 million of income, since the majority of the stock would be attributed to the U.S. remainderman. Thus, the U.S. remainderman would be subject to current taxation under the FPHC rules, even though the trustee could not make a distribution to the U.S. remainderman and therefore cannot convert a "deemed dividend" into a real dividend. But if the investment "pie" is smaller, the NRA's share is bigger, and the FPHC status may disappear. The investment company would not be an FPHC under the \$200,000 income scenario or under the current distributions allocation method.<sup>102</sup>

The example illustrates why there is no mechanical, or predictable, solution to these attribution questions. Indeed, a mechanical application of the actuarial or pure distribution methods would likely lead to unintended results in many cases. Furthermore, there is no accepted manner of applying these methods of attribution to purely discretionary foreign trusts or to many other cases that are much more complicated and common than our simple example. Given the difficulty in applying the actuarial and pure distribution allocation methods, it seems logical to consider seriously the merits of the facts and circumstances method of attribution. In applying this approach, distribution patterns and actuarial values would still be taken into account, but language in the trust instrument, and reasonable growth projections should also be considered relevant factors. As a result, the system would still fail to achieve predictable results.

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102. See Priv. Ltr. Rul. 87-48-043, *supra* note 97, in which a corporation was held in usufruct, and the Service ruled that the most relevant beneficial interest was trust income, not corpus.

*C. Failure to Respect the Trust Form*

The broader question raised by the difficulty of applying the rule of attribution to trust beneficiaries is whether the rule should be applied at all. Did Congress make a sound decision when it concluded that the FPHC and the CFC regimes, and the later enacted PFIC provisions, should be applied to U.S. beneficiaries of a non-U.S. trust as if their "proportionate" beneficial interest in the trust represented their share of the trust's stockholdings?

One perspective would suggest that this result is necessary to maintain the integrity of a system designed to combat offshore deferral of income taxes. Without it, the trust would appear to shield U.S. taxpayers from the effect of these rules and permit deferral. At least when the attribution rule for trusts holding investment companies was enacted in the mid-1980s, the deferral rules that applied to trusts alone were only modestly restrictive, as discussed earlier. The rules provided for only a six percent simple interest charge on the deferred tax that came due when the accumulations were later paid to U.S. beneficiaries, and a computational formula that was somewhat vulnerable to manipulation.<sup>103</sup>

Despite this undeniable hole in the defenses against offshore deferral, the step taken by Congress in adopting the trust attribution rule for investment companies was the wrong step. Attributing the stock to the trust beneficiaries as if they are shareholders violates the principle of respecting form and recognizing that form reflects substance. While it may be prudent to apply such an attribution rule for testing whether the investment company is owned by U.S. persons for some purposes, it is unrealistic to impute income to a U.S. beneficiary of a foreign trust by a mechanical attribution rule that purports to treat the beneficiary as if the shareholder rights held by the trustee are held by the beneficiary. The corporation pays dividends to the trustee, not to the beneficiary. The corporation recognizes the voting rights of the trustee, not the beneficiary. The existence of the form of the trust cannot be prudently legislated out of existence, as if all trustees were agents of the beneficiaries. A rule of form should not broadly destroy substance.

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103. In addition, it was sometimes argued that migration of the trust to the United States prior to the accumulation distribution could be considered as cleansing the later accumulation distribution of its offshore character, based on the language of the statute. While the Service ruled against this reading of the statute in 1991, it was not until 1997 that the statute was amended to preclude that conclusion. See I.R.C. § 665(c); Rev. Rul. 91-6, 1991-1 C.B. 89.

Trustees serve a substantive function under the trust form. The trust form is designed for the preservation of property by the trustee to aid the beneficiaries. The beneficiary is not a shareholder in the investment company. The beneficiary's role is quite different than that of an investor. In the typical trust, the beneficiary does not purchase his interest, does not have the opportunity to sell the interest, and may have little or no voice in who manages the trust. The trustee's decision on distributions is required by prevailing trust law to take into account the purposes of the trust, which ordinarily considers the needs of each of the beneficiaries. Distributions may vary in timing and amount over the course of time and depend upon events such as births and deaths, as well as family needs that bear little resemblance to a dividend policy for an investment company.

The anomalies presented by applying an attribution rule tied to actuarial value or current distributions point out a special characteristic of the trust form. Its inherent flexibility defies categorization as a means of parceling out corporate stock under the attribution rules for foreign corporations. The owner of the legal title in the trust form is clear: the trustee. But the beneficial owner is usually a class of owners whose composition and "share" changes with time and circumstances and the trustee's judgment. The fact that one-half of current income is distributed to Smith today tells us nothing about who will receive the second half that is accumulated; it may be Smith, or Smith's child, or Smith's uncle, or the deceased grantor's favorite charity. In a so-called "sprinkling" trust, Smith may receive a distribution today, and yet Jones will receive tomorrow's distribution. In still other cases where there may be only one beneficiary alive and none visible on the horizon, income may nevertheless be regularly accumulated in the Trustee's discretion to hold for unborn future generations. The seat occupied by the current beneficiary may have been provided simply to respect the family hierarchy, or to provide for a living person to oversee the trustee's management, or to cover some extraordinary emergency that is never likely to occur. How, in any of these cases, does one evaluate the interest of unborn beneficiaries? Are they presumptively U.S. persons or non-U.S. persons?

Another more fundamental question is whether the trustee's decision to accumulate income is presumed to be tax-motivated, either in all cases, or unless other legitimate purposes are demonstrated? If so, then the trust form is being ignored. If Congress actually intended to enact an automatic attribution rule, that decision can be justified only by the categorical assumption that the trust form can be broadly ignored without practical, non-tax consequences. This means in turn that all foreign trusts are assumed to be pure tax avoidance devices,

managed by a collusive or compliant trustee. That view of the statute therefore seems to impute to Congress an unreasonable and extreme conclusion.<sup>104</sup>

Alternatively, then, we might decide that the attribution rule should not be applied so broadly, or so automatically. But how would such a system be devised by regulation? The attribution rule could be applied to trusts in which the discretion of the trustee is very limited and the beneficial interests so clearly ascertainable that the trust is, for all practicable purposes, transparent. That is, however, only a small universe of cases. This leads to the further conclusion that the attribution rule has to be applied based on a facts and circumstances determination of the beneficial interest in each case. Yet that seems the antithesis of an attribution rule, and the factual inquiry would necessarily require a thorough examination of governing trust law and corporate law in almost every case. That process would be difficult enough if it were Delaware law at issue.<sup>105</sup> Applying non-U.S. trust law and non-U.S. corporate law would be much more cumbersome.<sup>106</sup> Assessing the element of tax avoidance motivation in the structure in order to test the bona fide nature of the trustee's role would further add to the burden of the inquiry.<sup>107</sup> The search for a satisfactory system seems fruitless.

A far better solution to this dilemma would have been for Congress to avoid it in the first instance. It could have taken the path of completely revising the tax treatment of accumulations in foreign trusts and avoided adopting the attribution rule for trusts holding offshore corporations. This approach, which would rely on adverse tax treatment for trust accumulations, places the tax burden at the trust level, where the trustee can more directly address the impact on U.S. beneficiaries of a later distribution. This approach appropriately precludes the possibility of the imposition of tax liability on a beneficiary for income that may never be distributed to or otherwise enrich that person. It also harmonizes the treatment of beneficiaries of trusts that hold their assets through investment companies with beneficiaries of trusts that do not use such companies. This approach allows the tax law to respect the form, and to appreciate that the trust form

104. This result would seem especially odd in the context of the new rules for determining whether a trust is a U.S. resident. A trust could be a "foreign trust" even if substantial decision-making powers are vested in a U.S.-based institutional trustee that is governed by its local trust law that clearly requires the trustee to be a fiduciary and not an agent of the beneficiary. Reg. § 301.7701-7(a).

105. See *Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir. 1999), *aff'g* 109 T.C. 177 (1997).

106. See *Estate of Oei Tjong Swan v. Commissioner of Int. Rev.*, 247 F.2d 144 (2d Cir. 1957).

107. See, *e.g.*, *Barnett v. Commissioner*, 44 T.C. 190 (1965).



reflects substance. The trust form simply cannot be squared with the view that the "true" shareholder of the offshore corporation is the beneficiary and that the trust is a mere agency of tax avoidance.

Now that Congress has in fact dramatically tightened the trust rules in the 1996 changes noted above, it would be fruitful to make an effort to harmonize the investment company and trust accumulation regimes by developing a thoughtful application of the Code's attribution rules. If creative solutions are not employed, then a broad application of the attribution rules will lead to a "Man Bites Dog" result—a rule of form will destroy the substance of U.S. taxation of international trusts.<sup>108</sup>

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108. For example, the "phantom income" result under section 1298(b)(5), *see supra* Part IV.A., is not inevitable. The regulations under the PFIC rules and the trust accumulation rules could be written to permit a distribution from a PFIC to a non-U.S. trust to be taxed only upon a later distribution from the trust to a U.S. person. The PFIC interest charge could be applied for the PFIC deferral period and the interest charge on trust accumulations applied to the later trust accumulation period. Using this approach, the phantom income result described would be avoided, while still maintaining the integrity of both anti-deferral regimes.