"The Complex Domestic Trust, a Potential Vehicle for Reducing the Tax on U.S. Source Non-Effectively Connected Dividend Income of Non-U.S. Persons and Capital Gains of Certain Corporations?"

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I. Introduction

By now we are all aware that the Jobs Growth Tax Relief Reconciliation Act of 2003[1] (the "2003 Act") reduced the tax rates applicable to "adjusted net capital gains"[2] (including for this purpose, "qualified dividend income"[3]) to 15%, at least with respect to adjusted net capital gains realized in taxable years beginning before January 1, 2009.[4] These tax rate reductions, which are found in Section 1(h), literally apply only for purposes of determining the tax imposed by Section 1. Section 1 imposes taxes on individuals. Section 1(e) applies to trusts and estates and as a result, the reduced tax rates applicable under Section 1(h) also applies to the adjusted net capital gains of trusts and estates. Section 1(h) has no direct application to the tax imposed on corporations or to the taxes imposed with respect to the non-effectively connected, fixed, determinable annual or periodical income of nonresident alien individuals.[5]

Since a trust or estate may have a nonresident alien individual as a beneficiary, the benefit of the reduced tax rates accorded by Section 1(h) in respect of qualified dividend income could be made available to U.S. source non-effectively connected dividend income of nonresident alien individuals, a result which although not seemingly

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1 P.L. 108-27.

2 See Section 1(h)(1)(c). Unless otherwise noted, all section references are references to the Internal Revenue Code of 1986, as amended (the "Code").

3 See Section 1(h)(11).

4 P.L. 108-27, section 303.

5 Section 871(a). Cf. Section 881(a).

intended by the 2003 Act, is not one that disturbs my sensibilities.[6] But suppose a trust could have a corporation as a beneficiary. Does that mean that the rates applicable under Section 1(h) could be applied to net capital gains ultimately paid out to a corporate beneficiary? An affirmative answer might well follow from a quick and literal reading of the applicable provisions. As will be seen below, the circumstances will be few and far in between where the stars will align in a manner that would allow for such corporate rate reduction. But, as this paper indicates, it does not appear to be impossible.

How then did we get here? It is thought that throughout history, a series of environmental changes, no one of which would even have been noticeable at the time it was occurring, have in combination and over time in retrospect acted as a catalyst for evolutionary changes and even the creation of new species.[7] When Congress changed the tax landscape with The Taxpayer Relief Act of 1997 (the "1997 Act")[8] which, in part, repealed then current Section 644 and revised Section 665, the seed for such a change in the environment may have been sown, albeit not widely noticed if noticeable at all. Coupled with recent changes made by the "2003 Act", the changes and their possible unintended effects, which have been "blowing in the wind" since 1997, will have no doubt become more apparent.

By way of background, prior to its repeal by the 1997 Act, Section 644 imposed a special tax on certain sales of built-in-gain property transferred to trusts. The 1997 Act

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6 See text at notes 81-83 infra.

7 *See, e.g.*, Eldridge, *Species, Speciation and the Environment*, An actionbioscience.org original article at http://www.actionbioscience.org/evolution/eldredge.html (Oct. 2000). Please note that the author is not trained as a scientist and as such, misuse of scientific concepts and terms is probable and due solely to the author's general ignorance on these matters. Readers are strongly discouraged from relying on or citing this article for academic works in the scientific fields. They may also want to think twice about applying the ideas discussed in this article in their tax-related fields of practice. Stated differently: "Kids, don't try this at home."

8 P.L. 105-34.

also revised Section 665 to exempt distributions made by most domestic trusts from the "throwback" rules that had been applicable to the taxation of certain "accumulation distributions" from all types of trusts. These changes were made because "Congress determined that the insignificant potential tax reduction available through the transfer of property to trusts no longer warranted the complexity of the throwback rules and Section 644."[9] As we will see, simplification can be a complex business. These simplifying changes to the trust taxation environment may have created a possibly unintended consequence that stands to make the tax reduction from such changes not as insignificant as Congress may have thought.

Because of the way in which domestic trusts and their beneficiaries are taxed with respect to trust income and distributions in the absence of former Section 644 and the throwback rules, if a trust is taxed at a lower rate than a particular beneficiary with respect to a specific class of income, having income-producing property held in a domestic trust could result in significant tax reduction. Thus, in the current tax environment and under the "proper" circumstances, the Section 1(h) rates may apply if, for otherwise valid reasons, a trust just happens to be involved, regardless of whether Section 1 would apply to the income of such trust's beneficiaries had such income been earned directly.

As background, this paper sets forth the basic rules relating to trust classification and the federal income taxation of U.S. trusts and beneficiaries and explains the trust rules changed by the 1997 Act. Next, follows a discussion of the nature of the trusts to which these rules apply. The tax implications resulting from the formation of a trust to

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[9] Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in 1997, Dec. 17, 1997 p. 77. *See also* Committee Report of the House Ways & Means Committee on Taxpayer Relief Act

which the Section 1(h) rates may apply is then covered. Finally, the possible vulnerabilities of an arrangement designed to take advantage of these rules to their natural predator, the Internal Revenue Service (the "Service"), will be discussed.

II. What is a Trust for Federal Tax Purposes?

Obviously one must start with a trust, *i.e.*, an entity which is classified as a trust for federal income tax purposes and not an imposter association or partnership camouflaged as a trust. An entity that is in the form of a trust and has all the bells and whistles needed to comply with controlling state law regarding trusts, must nonetheless be considered a trust for federal tax purposes in order to be taxed as a trust in accordance with the rules outlined below. If an entity is not classified as a trust for tax purposes, it is simply a business entity which would then be classified under the "check-the-box" regulations either as a partnership or an association taxable as a corporation.[10] The regulations define a trust as follows:

> In general, the term "trust" . . . refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually, the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. . . . Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of a business for profit."[11]

Generally, a trust will not be treated as a business entity for tax purposes unless the trust is a medium for conducting a business and trust beneficiaries are in the

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of 1997 (H.R. 2014), June 27, 1997, p. 321.

[10] Treas. Reg. §301.7701-2(a).

enterprise of conducting that business (*i.e.*, the beneficiaries are "associates").[12] The regulations treat a "business" trust, that is, a trust created by beneficiaries "simply as a device to carry on a profit-making business which normally would have been carried on through business organizations classified as corporations or partnerships" as a business entity since it has a business and associates.[13] On the other hand, an "investment" trust will not be classified as a business entity as long as there is no power to vary the investment of the interest holders (beneficiaries) of the trust because even though such a trust has associates, it does not have a business.[14]

Regardless of whether a trustee actually exercises powers granted under a trust instrument, if the trustee is granted even narrow powers to vary trust assets, a trust could be considered a business.[15] However, in order for trust beneficiaries to be considered associates for purposes of classifying a trust as a business entity, there must be some sort of volitional activity on their part to become associated with the business.[16] Thus, persons that receive a beneficial interest in a trust gratuitously or otherwise through no actions of their own and do not participate in trust management or administration are not associates even if the trust is conducting business activities. Consequently, a trust that technically may be considered to have a business because trustees may vary trust assets

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11 Treas. Reg. §301.7701-4(a).

12 *See, e.g.,* Morrissey v. Commissioner, 296 U.S. 344 (1935); Elm Street Realty Trust v. Commissioner, 76 T.C. 803 (1981), *acq.* 1981-2 C.B. 1; and H.M. Bedell v. Commissioner, 86 T.C. 1207 (1986), *acq.* 1987-2 C.B. 1.

13 Treas. Reg. §301.7701-4(b).

14 Treas. Reg. §301.7701-4 (c).

15 *See, e.g.,* Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), *cert. den.,* 314 U.S. 701 (1942).

16 Morrissey, *supra, n* .12; Elm Street Realty Trust, *supra, n.* 12 ; H.M. Bedell *supra, n.* 12; Water Resource Control v. Commissioner, 61 T.C. Memo 2102 (1991); U.S. v. Davidson, 115 F.2d 799 (6th Cir. 1940); and Curt Teich Trust No. One v. Commissioner, 25 T.C. 884 (1956), *acq.* 1956-2 C.B. 8. *See also,* Priv. Ltr. Rul. 8842043 (July 26, 1988).

will nonetheless be taxed as a trust if the beneficiaries of the trust do not voluntarily associate themselves with the trust.

III. Federal Income Taxation of Trusts and Beneficiaries

Except where otherwise noted, this discussion is limited to the basic rules governing the federal income taxation of domestic complex trusts that are not subject to the grantor trusts rules of Sections 671 through 679.[17] A domestic trust is one for which (i) a court within the United States is able to exercise primary supervision over the administration of the trust and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.[18] A complex trust is generally any trust other than one which under its terms is required to distribute all of its income currently.

Subchapter J of the Code governs the income taxation of trusts and beneficiaries.[19] A trust is taxed on its taxable income at the rates specified in Section 1(e).[20] For 2003, income tax is imposed at a maximum rate of 35% on a trust's taxable income, which maximum rate applies to trust income in excess of $9,350. A trust's net capital gain is subject to taxation at the reduced rates prescribed by Section 1(h). The 2003 Act reduced the 20% capital gains rate to 15% for years ending on or after May 6, 2003 and also applied the 15% rate to dividends paid by most domestic and foreign corporations after December 31, 2002 by characterizing such "qualified dividend

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17 For a more detailed discussion of the rules relating to federal income taxation of domestic trusts, *see* Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* Vol. 3A, Ch. 81 (2d ed., as supplemented 2001). For a discussion of the tax treatment of foreign trusts and grantor trusts, see, respectively, Wyckoff, *U.S. Taxation of Foreign Trusts: Parts One and Two*, 59 N.Y.U. Inst. Tax. 20 and 21 (2001); and Zaritsky, 858-2nd T.M., *Grantor Trusts: Sections 671-679*.

18 Section 7701(a)(30)(E).

19 Section 641, *et seq*.

20 Section 641(a).

income" as net capital gain for purposes of Section 1(h).[21] The taxable year of any trust other than an exempt or charitable trust is the calendar year.[22]

The taxable income of a trust is computed in the same manner as in the case of an individual except as otherwise provided, with the most notable difference being that a trust is allowed a deduction for distributions made to beneficiaries in the current tax year.[23] The deduction for distributions is equal to the sum of (i) the amounts of income for the year that the trust is required to distribute pursuant to its governing terms (referred to herein as "required distributions") and (ii) any other amounts paid or credited or required to be distributed (to the extent distributed from trust corpus rather than current income) for such taxable year (referred to herein as "discretionary distributions").[24] However, the amount of the distribution deduction is limited to the trust's distributable net income ("DNI") for the year. In the absence of an allocation of different classes of income under the specific terms of a trust instrument, amounts distributed by a trust are treated as consisting of the same proportion of each class of income entering into the calculation of DNI as the total of each class bears to total DNI.[25]

A beneficiary to whom required or discretionary distributions are made must include such distributions in gross income to the extent of the distributing trust's DNI for the year.[26] If a trust has DNI for the year, any distribution made or considered made during that year will carry out DNI (and consequently, income) regardless of the actual

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21 Sections 301 and 302 of the 2003 Act.
22 Section 644.
23 Sections 641(b) and 661(a).
24 Section 661(a).
25 Section 661(b).
26 Section 662(a).

source of the funds for such distribution.[27] To the extent distributions from a trust exceed the trust's DNI for that year, beneficiaries do not include trust distributions in gross income. Distributed amounts have the same character in the hands of the beneficiary as in the hands of the trust and are treated as consisting of the same proportion of each class of items entering into DNI as the total of each class bears to total DNI unless the terms of the trust instrument specifically allocate different classes of income to different beneficiaries.[28]

A trust's DNI for a taxable year is the trust's taxable income with the following modifications: (i) no deduction for trust distributions to beneficiaries is allowed; (ii) no personal exemption deduction is allowed; (iii) certain capital gains and losses are excluded; (iv) certain extraordinary and taxable stock dividends are excluded; and (v) tax-exempt interest (as reduced for allocable deductions) is included.[29] A trust's capital gains are generally excluded from DNI to the extent they are allocated to trust corpus and are not distributed to a beneficiary during that taxable year or paid or set aside for charitable contributions.[30] A trust's capital losses are excluded from DNI except to the extent that capital gains are so included.

> **Illustration:** Trust (T) has one beneficiary (B) to whom the trustee may make wholly discretionary distributions of trust income or corpus in any year.
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> **Year 1 (Y1)**: T realizes $40,000 income as follows: $20,000 from dividends; $10,000 of taxable interest; and $10,000 from the sale of a capital asset with a holding period of over one year. In accordance with

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27 Pursuant to Section 663(b), trustees may elect to treat distributions made within the first 65 days of the tax year of the trust as paid on the last day of the preceding taxable year.

28 Section 662(b).

29 Section 643.

30 However, if a trustee follows a regular practice of distributing the exact net proceeds from the sale of trust property or other facts indicate an intention to currently distribute gains, capital gains will be included in DNI regardless of whether the trustee allocates the gain to corpus. *See* Treas. Reg. §1.643(a)-3(d). Capital gains are not excluded from the DNI of foreign trusts. Section 643(a)(6)(C).

the trust document, T allocates the capital gain to corpus and makes a distribution of $20,000 to B.

Y1 DNI = $30,000 ($20,000 dividends + $10,000 interest). $10,000 capital gain is excluded from DNI.

T's Income = $20,000 ($40,000 income - $20,000 distribution deduction). Income consists of $10,000 long-term capital gain taxed at 15% and $6,700 dividend income and $3,300 interest income taxed at ordinary income rates.

B's Income = $20,000 consisting of $13,300 dividend income and $6,700 interest income.

Year 2 (Y2): T earns $20,000 of dividend income which is reinvested in additional stock. T distributes the $10,000 retained capital gain earned in Y1 to B.

Y2 DNI = $20,000.

T's Income = $10,000 from dividends ($20,000 income - $10,000 distribution deduction).

B's Income = $10,000 dividend income. The distribution carries out Y2 DNI and income character notwithstanding that the source of the distribution was Y1 capital gain.

Year 3 (Y3): T realizes $10,000 from dividends and distributes $15,000 to B.

Y3 DNI = $10,000.

T's Income = $0 ($10,000 income - $10,000 distribution deduction). Distribution deduction is limited to DNI.

B's Income = $10,000 dividend income. The remaining $5,000 distribution is not taxed to B since that portion of the distribution exceeds Y3 DNI.

Summarized in the most basic terms, these rules operate such that: 1) trust income that is currently distributed retains its character in the hands of the recipient beneficiary and is taxed to such beneficiary under the income tax rules applicable to that beneficiary; 2) trust income that is not distributed in the year it is earned is subject to

income tax in the hands of the trust; and 3) if the trust distributes its accumulated income in a subsequent year, the beneficiary who receives that income will not be taxed on it except to the extent that the trust has otherwise undistributed DNI in that year. Prior to the changes made by the 1997 Act exempting domestic trusts from the throwback rules and repealing Section 644, taxation of trusts and their beneficiaries was not necessarily so simple.

IV. Certain Rules Applicable to Trusts Prior to the 1997 Act

A. Throwback Rules

The throwback rules do not apply to distributions made from most domestic trusts after August 5, 1997.[31] However, the rules continue to apply to all foreign trusts and to domestic trusts that either were previously foreign trusts (unless an exception under the regulations applies) or would be subject to the multiple trust rules of Section 643(f).[32]

Under these rules, a throwback to earlier tax years is required when (i) a trust makes an "accumulation distribution" in one taxable year and (ii) such trust had "undistributed net income" in one or more preceding taxable years. A trust makes an accumulation distribution in any year in which the total of its discretionary distributions for the year exceeds its DNI for that year as reduced by the amount of any required distributions, *i.e.*, accumulation distribution = discretionary distributions – (DNI – required distributions).[33]

> **Illustration**:[34] Under the terms of the trust, all distributions are discretionary. Assume the throwback rules apply to the trust. The only year in which distributions would have exceeded DNI was Y3.

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31 The throwback rules are codified at Sections 665 through 668.

32 Section 665(c).

33 Section 665(b).

34 Except as otherwise noted, all illustrations in this section IV are based on the facts set forth in the illustration from the immediately preceding section.

Y3 accumulation distribution = $5,000 ($15,000 discretionary distribution - $10,000 DNI).

A trust has undistributed net income ("UNI") with respect to a preceding tax year if and to the extent that its DNI for that year exceeds the sum of (i) its required and discretionary distributions in such year and (ii) the taxes imposed on the trust attributable to such excess DNI.[35]

Illustration: **Y1 UNI** = $6,500 ($30,000 DNI – ($20,000 distributions + $3,500 tax[36])).

Y2 UNI = $6,500 ($20,000 DNI – ($10,000 distribution + $3,500 tax)).

Once it is determined that a trust has made an accumulation distribution and that it has UNI for preceding taxable years, Section 666 operates to allocate (*i.e.*, throw back) the accumulation distribution to the preceding tax years for which UNI exists. Starting with the earliest year in which the trust has UNI and moving forward in time, the accumulation distribution is deemed to be a discretionary distribution from the trust in each year in which there is UNI, to the extent of that UNI.

Illustration: The entire Y3 $5,000 accumulation distribution would be allocated to Y1. Y1 UNI would be reduced to $1,500 ($6,500 - $5,000) and Y2 UNI would remain $6,500.

If T had made an accumulation distribution in Y3 of $15,000, $6,500 would have been allocated to each of Y1 and Y2 and the remaining $2,000 would not have been allocated to an earlier year because it exceeded T's total UNI.

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35 Section 665(a).

36 Because only T's $10,000 of ordinary income entered into its DNI calculation in year 1, only the tax on that $10,000 of income can be subtracted. Tax paid on the capital gain is disregarded. The application of these rules with respect to the illustrations assumes a 35% tax rate on ordinary trust income.

In addition to the amount of UNI that is deemed distributed in a preceding tax year under the throwback rules, an amount equal to the taxes imposed on the trust attributable to each of the deemed UNI distributions is also deemed distributed to the beneficiaries in that year.[37]

> **Illustration**: Y1 total deemed distribution = $6,750 ($5,000 UNI distributed + $1,750 T's tax attributable thereto).

A beneficiary's tax liability with respect accumulation distributions (including the deemed distribution of taxes paid) is computed under Section 667. Although the intent of Section 667 is generally to tax a beneficiary who receives an accumulation distribution as if he had received the distribution in the tax year(s) to which such income is allocated, the actual tax imposed on the beneficiary must be computed under a specific method prescribed by Section 667. Under this method, the total accumulation distribution is divided by the number of years to which it was allocated to arrive at an average distribution. Next, the beneficiary eliminates from his five taxable years immediately preceding the year in which the accumulation distribution was made (regardless of whether the distribution is allocated to those years) the years of his highest and lowest taxable income. The amount of the average distribution calculated in the first step is then added to the beneficiary's income for each of those three years and the beneficiary's increased tax liability for each of those years as a result of the increased income is determined. This increase in tax liability for the three years is then averaged and that average is multiplied by the number of years to which the accumulation distribution was actually allocated to arrive at a total amount of increased taxes. The beneficiary must pay income tax on the amount by which this total amount of increased taxes exceeds the total

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[37] Section 665(b).

taxes deemed distributed by the trust (*i.e.*, in effect, the beneficiary receives a credit for taxes paid by the trust on the accumulated income).[38]

> **Illustration**: Assume B's federal tax rate was 35% for each of the years in question.
>
> **Avg. Accum. Dist.** = $6,750 ($6,750 total distribution / 1 year)
>
> $6,750 is added to B's income in Y1 and Y2 because only two years precede the accumulation distribution.
>
> **Tax Increase** = $2,363 for each of Y1 and Y2 ($6,750 x 35%)
>
> **Avg. Tax Increase** = $2,363
>
> **Total Increased Taxes** = $2,363 ($2,363 avg x 1 year to which allocated)
>
> **Additional Tax Due from B** = $613 ($2,363 - $1,750 taxes deemed distributed by T).

B. Section 644[39]

If property with a built-in-gain were transferred to a trust, Section 644 generally imposed a special tax on the trust if such property were sold at a gain within two years of the date of the initial transfer to the trust. Although the Section 644 tax was imposed on the trust, the amount of the tax was measured by reference to the transferor of the property. The Section 644 tax was imposed against the "includible gain" which is the lesser of (i) the built-in-gain in the property at the date of transfer to the trust and (ii) the trust's actual recognized gain from the sale. The amount of the Section 644 tax was equal to the amount by which the transferor's income tax liability would have increased if

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[38] In the case of accumulation distributions from a foreign trust, Section 668 also imposes an interest charge on the increased tax.

[39] For purposes of this discussion, references to Section 644 are to the former Section 644 as existed immediately prior to its repeal by the 1997 Act.

the includible gain had been included in the transferor's income for the year of sale.[40] The amount of the includible gain was not included in the trust's gross income and thus did not enter into DNI.

> **Illustration**: Assume that the capital asset sold by T in Y1 had built-in-gain of $10,000 at the time it was transferred to T by C, a corporation. The sale of the capital asset by T in Y1 would have triggered Section 644 because T sold the built-in-gain property within two years. Assume C's applicable tax rate is 35%.
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> **C's Y1 tax increase** = $3,500 ($10,000 includible gain x 35%).
>
> T is required to pay tax of $3,500 under Section 644 and excludes the gain from its Y1 income. Note that in the absence of Section 644, T paid tax of $1,500 on the gain.

V. The Stirrings of a Structure

Familiar with these foundations, one can begin to appreciate how the 1997 changes could have an impact of greater significance than perhaps might have been intended. First, we know that income accumulated by a trust is taxed at the trust level. Second, we know that taxes are imposed on trusts at the rate generally prescribed by Section 1 (*i.e.*, the individual rates), including Section 1(h), rather than rates prescribed by Section 11, 871 or 881. Third, if that trust distributes the accumulated income to a beneficiary in a subsequent year in which there is no otherwise undistributed DNI, the beneficiary does not include the distribution in income. Because the throwback rules no longer apply to distributions from domestic trusts, a beneficiary receiving an accumulation distribution does not have to pay any additional "special" tax on that distribution. Moreover, if trust income arose from the sale of property transferred to the

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[40] An additional interest charge was also imposed if the trust and the transferor had different tax years and this difference resulted in a delay of the payment of tax because the measurement of increased tax could not be made until the end of the transferor's tax year.

trust (and such gain is not otherwise attributable to the transferor[41]), because former Section 644 was repealed, that gain is taxed only by reference to the trust and not by reference to the circumstances of a different taxpayer.

For example, absent the application of a reduced rate of tax under a tax treaty,[42] a nonresident alien individual or foreign corporation would be subject to a 30% tax on U.S. source dividend income.[43] However, as a result of the 2003 Act, a domestic trust would be subject only to a 15% tax on such income.[44] If instead of nonresident aliens or foreign corporations owning U.S.-source dividend paying stock, such stock were owned by a domestic trust of which the non-U.S. persons were the beneficiaries, these dividends could be subject to tax at the lower 15% rate if earned and retained for a period by the trust. Such a trust would be subject to tax at a 15% rate on its long-term capital gains and its qualified dividend income, even if the beneficiary were a U.S. corporation which would have been subject to a 35% tax on its capital gain. Having gone this far, one might suggest that taken to an illogical extreme, and with planning and patience, the corporate capital gains tax rate has been reduced to 15%. Obviously too good to be true. Or is it?

Clearly such structures would have advantages, but could they spring to life outside of controlled conditions and avoid being devoured by the Service? Certain factors must exist (or not exist) in order for a sustainable structure to develop. For instance, there can be no reduction in tax where the otherwise high-taxed taxpayer is both the grantor and a beneficiary of the trust.[45] In that case, the grantor would be treated as

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41 *Cf.* Commissioner v. Court Holding Co., 324 U.S. 331 (1945); U.S. v. Cumberland Public Service Co., 338 U.S. 451 (1950); and National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), *cert. den.* 320 U.S. 794 (1943).

42 *See, e.g.*, Article 10 of the U.K. – U.S. Income Tax Treaty.

43 Sections 871(a)(1) and 881.

44 Section 1(h)(11).

45 *But cf.* Section 672(f).

directly owning trust assets and income under the grantor trust rules and such income would be taxed at the grantor's higher rate.[46] Thus, there must actually be at least two persons subject to higher tax rates than a trust to sustain the structure – one to fund the trust and one to receive a beneficial interest in the trust. If the grantor of the trust were not subject to higher tax rates than the trust, he/it would have no tax incentive to make the transfer to the trust in the first place. The grantor must also be willing to divest rights of control with respect to trust income and assets such as a power to revoke the trust or to direct trust distributions. If retained, these rights would cause the trust to be treated as a grantor trust and again the income would be taxed directly to the grantor at his/its higher rate. Moreover, the trust beneficiary must receive its interest other than through its own volition and cannot otherwise have powers with respect to the management of trust assets. Otherwise, assuming the trustees have the power to vary trust assets, the trust could be classified as a business entity and would be taxed as either a corporation or a partnership. If treated as a corporation or a partnership, a trust would be unable to obtain the benefit of the rates applicable under Section 1(h) on its accumulated income.

Despite these somewhat limited conditions, there are scenarios in which it would be possible to achieve tax savings. Turning back to the two categories of taxpayers and income mentioned before – a nonresident alien with dividend income and a corporation with potential capital gains, let us first focus on nonresident aliens.

> **Scenario 1 (S1):** A, a nonresident alien individual not resident in a country with which the U.S. has a tax treaty, owns various investments assets that generate U.S.-source income, including stock in U.S. corporations. A will transfer these investment assets to an irrevocable domestic trust ("AT") for the benefit of his children B, C and D, who are also nonresidents. AT will have one or more independent trustees who will have the power to manage the investments of AT, including the power

[46] Section 677.

to dispose of, reinvest and distribute AT property. Under the terms of the AT trust instrument, the trustees are required make current distributions of AT income other than dividend income among the beneficiaries entirely within their discretion. The trustees are required under the trust instrument to reinvest all dividend income earned by AT.

AT would be classified as a trust for tax purposes because even if the powers granted to AT trustees amounted to a business, AT does not have associates since B, C and D would receive their beneficial interests as a result of gratuitous transfers. Moreover, A would not be treated as the owner of the AT assets and income under the grantor trust rules since he does not retain any interest with respect to trust assets or income. In fact, the circumstances in which a trust settled by a foreign person is treated as a grantor trust are limited and AT could possibly be structured to give A or his spouse a beneficial interest in the trust.[47]

Going forward, current distributions of AT income would not be considered to consist of dividend income since, under the terms of the AT trust instrument, that income must be reinvested and cannot be distributed (*i.e.*, allocated) to any beneficiary. Thus, if B, C or D received current distributions, each would be considered to have received his proportionate share of AT non-dividend income and would pay any U.S. taxes applicable to him with respect to that income. AT would pay tax at a rate of 15% with respect to the reinvested dividend income. Moreover, withholding at the source would not be required on such dividend income. If AT had not been formed and A had realized the dividend income, A would have been subject to tax at a 30% rate on such income under Section 871(a)(1), and such tax likely would have been withheld by virtue of Section 1441.

Example 1A: Y1: AT earns $60,000 of U.S.-source interest from corporate bonds and $30,000 of dividends from U.S. companies. AT reinvests the $30,000 of dividends as per the trust agreement in U.S.

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47 *See* Section 672(f) and Treas. Reg. §§1.672(f)-1 and 1.672(f)-3.

Treasury notes. AT distributes the $60,000 of interest income evenly between B, C and D.

DNI = $90,000 ($60,000 + $30,000).

AT Income = $30,000 specially allocated dividend income ($90,000 - $60,000 distribution deduction).

AT Tax = $4,500 ($30,000 x 15% rate on qualified dividend income).

B/C/D Income = $20,000 each of interest income.

B/C/D Tax = $0 (tax exemption for portfolio interest).

AT's trustees could distribute reinvested dividend income in a subsequent year by liquidating the investment and distributing the proceeds therefrom. As long as AT did not earn any dividend income in the year such proceeds were distributed, AT's beneficiaries would not pay U.S. taxes on these distributed amounts. Of course, the beneficiaries would still have to pay any applicable U.S. taxes on any current non-dividend trust income distributed to them in that year. Moreover, the distributions relating to reinvested dividends would need to be made to the same beneficiaries who received current income distributions and in the same proportions or the distribution of such amounts would carry out a portion of AT's DNI for that year and would be partially taxable to the recipient.

Example 1B: Y3: AT sells one-half of the treasury notes for $33,000, realizing a capital gain of $3,000. AT also realizes $60,000 of interest income from corporate bonds and U.S. Treasury notes. AT distributes $31,000 to each of B, C and D consisting of $20,000 of interest and $11,000 from the sales proceeds of treasury notes, for a total distribution of $93,000.

DNI = $63,000 (DNI includes capital gain because it is currently distributed).

AT Income = $0 ($63,000 income - $63,000 distribution deduction). Distribution deduction limited to DNI.

AT Tax = $0

B/C/D Income = $21,000 each, comprised of $20,000 interest and $1,000 capital gains. Remaining amount of distributions not income because they exceed DNI.

B/C/D Tax = $0 (portfolio interest, government bonds and capital gains exemptions).

Example 1C: Y3: Same as example 1B except AT also earns $6,000 of dividend income which it reinvests.

DNI = $69,000 (DNI includes dividends even if they cannot be distributed).

AT Income = $0 ($69,000 income - $69,000 distribution deduction). Distribution deduction limited to DNI.

AT Tax = $0

B/C/D Income = $23,000 each comprised of $20,000 interest, $1,000 capital gains and $2,000 dividends. Although the trust instrument requires dividends to be reinvested, distributions will carry out all available Y3 DNI.

B/C/D Tax = $600 each ($2,000 dividend income x 30%).

If the throwback rules were still applicable, distributions by AT relating to reinvested dividends would be subject to tax in the hands of the beneficiaries. In examples 1B and 1C, AT would have made an accumulation distribution in Y3 since Y3 distributions exceeded Y3 DNI. The Y1 dividend income included in Y1 DNI would have resulted in UNI and a throwback for Y1.

The trust structure in S1 clearly results in an overall tax savings and its implementation in the family context seems natural. However, a trust structure involving a corporation with potential capital gain income may appear less likely to evolve since

one does not typically think of trusts in the corporate context. Certainly corporations have established deferred compensation trusts for employees or even charitable trusts, but can corporations establish "true" trusts outside of these contexts? The regulations seem to contemplate that they can.

For purposes of all but a small part of Subchapter J that is not relevant to this article, the regulations provide that "a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer . . . of property to a trust."[48] Specifically, where a corporation makes a gratuitous transfer to a trust for a business purpose, the corporation will generally be treated as the grantor of the trust.[49] Although Section 671 is contained in the subpart of Subchapter J addressing grantor trusts, these particular provisions apply for purposes of the trust taxation rules of Sections 641 through 685 and simply operate to identify the grantor of a trust. Even in the case where the grantor trust rules would apply, these rules do not question the status of the trust (*i.e.*, the classification of a trust as such under Treas. Reg. §301.7701-4), but rather operate to treat the grantor as the owner of trust assets. Thus, consistent with the regulations under Section 671, a corporation can establish a trust and, as long as that trust would be treated as such under Treas. Reg. §301.7701-4 and the corporation does not retain powers with respect to the trust that would cause it to be the owner of trust assets, the taxation of the entirety of the trust's assets, income and distributions would be governed by the rules summarized at the outset of this article.

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48 Treas. Reg. §1.671-2(e)(1). *Emphasis added.*

49 Treas. Reg. §1.671-2(e) (4). *See also* Treas. Reg. §1.672(f)-2(d), Ex. 1 (corporation that creates and funds trust is treated as the grantor of that trust).

So it seems that a corporation can form a trust, but are there situations in which the corporate party can benefit without the trust structure being rendered extinct by the Service? As a basic matter, for this trust structure to survive its first day, it must have been formed for some plausibly legitimate business reason. While at first blush this limitation would cause many skeptical tax professionals, of which I am one, to consider stopping here, upon closer inspection, there are likely to be many situations where there are overwhelming business reasons which could easily get us to want to read on. Consider the following obvious example.

> **Scenario 2 (S2)** – U.S. parent corporation ("P") owns 100% of the stock of domestic subsidiary corporations U ("U") and W ("W"). U and W conduct separate businesses. Although W's business is consistent with P's future business plan, it is not clear whether U's business will fit as well into that plan. P has not made a definitive decision to dispose of U and has not received any offers from third parties to acquire the stock or assets of U. Indeed, there is considerable controversy regarding whether there should be a disposition. P's basis in the U shares is $10,000 and the fair market value of the shares is $20,000.
>
> P will transfer all of the U stock to an irrevocable trust ("PT") with one or more independent trustees (outside directors if you will) under which W will be the sole beneficiary. Under the terms of the PT trust instrument, the trustees may within their discretion make current distributions to W of all T income other than capital gains. If PT recognizes capital gains, the trustees will be required to reinvest the proceeds from the transaction generating such gain. PT trustees may make distributions of trust corpus to W within their discretion in any year in which a transaction generating significant capital gain has not occurred. The trustees will have the power to manage investments of PT, including the disposition and reinvestment of PT property.

It is submitted that for the reasons earlier discussed, PT would be classified as a trust for tax purposes because even if the powers granted to PT trustees amounted to a business, PT does not have associates since W did not voluntarily acquire its beneficial interest. Moreover, P would not be treated as the owner of the PT assets and income

under the grantor trust rules since it does not retain any interest with respect to trust assets or income.

At the outset, the only asset of PT is U stock, so absent a disposition of such stock by the trustees during the first year of PT, the only income PT could receive during that period would be with respect to distributions, if any, by U. The tax treatment of any distribution received by PT from U would be determined under Sections 316 and 301.

> **Example 2A**: Y1: PT receives $10,000 in distributions from U which are treated as dividends under Sections 316 and 301. PT distributes $5,000 to W.
>
> **DNI** = $10,000
> **PT Income** = $5,000 ($10,000 - $5,000 distribution deduction).
> **PT Tax** = $750 ($5,000 x 15%)
> **W Income** = $5,000 dividend income.
> **W Tax** = $525 (($5,000 - $3,500 dividends received deduction) x 35%). (15% dividend rate does not apply to corporations.)

Now assume that during PT's second tax year a third party approaches PT with an offer to purchase 100% of the stock of U for $20,000 and, determining that it is in the best interest of W, the trustees sell the stock of U to the third party.

> **Example 2B**: Y2: PT recognizes $10,000 capital gain ($20,000 proceeds - $10,000 basis[50]). PT is required to reinvest the after-tax proceeds and places them in an interest-bearing account. PT receives no other income and makes no distributions to W.
>
> **DNI** = $0 (capital gain not included in DNI).
> **PT Income** = $10,000 capital gain.
> **PT Tax** = $1,500 ($10,000 x 15%)
> **W Income** = $0
> **W Tax** = $0

In PT's third year, assume that the trustees decide to liquidate all trust assets and distribute all proceeds to W.

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[50] Basis and holding period rules are discussed below.

Example 2C: Y3: PT earns $1,500 interest from the reinvestment of sales proceeds from U stock. PT distributes all of its assets to W which amount to $20,000 ($18,500 after-tax sales proceeds and $1,500 earned interest).

DNI = $1,500
PT Income = $0 ($1,500 - $1,500 distribution deduction).
PT Tax = $0
W Income = $1,500 interest income. Remaining distribution is not income because it exceeds DNI.
W Tax = $525 ($1,500 x 35%).

Prior to the 1997 Act, Section 644 would have imposed a tax on PT in Y2 measured by reference to P since the U stock was sold within two years and had built-in-gain at the time it was transferred to PT. P's increased tax in Y2 would have been $3,500 ($10,000 includible gain x 35%). Under Section 644, PT would have paid the $3,500 tax and excluded the gain from its Y2 income. Even prior to the 1997 Act, however, the throwback rules would not have applied to the Y3 distribution because the capital gain from the sale of U stock in Y2 would not have been included in DNI and thus would not have resulted in UNI for Y2.[51]

One of the collateral consequences of the method P chose to consider disposition of the U shares is that the capital gain from the sale of subsidiary stock is taxed at a 15% rate even though the proceeds of the sale may eventually end up back in the corporate solution. It almost sounds too good to be true and it probably is unless the structure is established for a business purpose. Thus, the utility of such a structure may be rather limited in scope since the situations in which a plausible business purpose for creating a trust structure like that in S2 are admittedly few. Moreover, the author has not considered, and does not purport to draw any conclusions regarding, the limitations, if

[51] Prior to the Tax Reform Act of 1976, throwback rules also applied with respect to certain distributions of accumulated capital gains.

any, that the fiduciary duties of corporate officers and/or board members (and applicable disclosure requirements were P a public company) would impose on introducing a trust with independent trustees into the corporate structure. It could be that such limitations and/or other business practicalities render this discussion largely academic, but since you have read this far, it is only fair to discuss a couple of possible applications.

First, suppose in S2 that P were the parent holding company of a global conglomerate created as a result of various corporate combinations and acquisitions among numerous financially significant corporations. The businesses of these component companies are diverse and not necessarily compatible. P's executives and managers are comprised mostly of individuals who held high-level positions at the component companies and rumor has it that the differing loyalties and management styles of these individuals have resulted in a relationship among them that is less than congenial and productive. Certain powers at P have determined that divestitures of certain businesses might benefit the overall economic health of the company, but no decisions have been made or consensus reached in this regard. Because of the existing managerial environment, P decides to place the stock of one or more of these companies in trust for the benefit of one or more subsidiaries within the P group, with the understanding that the independent trustees of PT will make all future decisions with respect to the stock of the transferred subsidiary. In this situation, there is arguably a good business purpose for introducing the trust since some corporate restructuring may be needed, but is unlikely to occur in the current confrontational business environment.

Alternatively, if P were attempting to acquire another corporation or business, P would have a business purpose for transferring stock of an existing subsidiary to PT

where the ownership of such stock by P would raise antitrust concerns. The trustees of PT would make the decisions regarding U stock in accordance with any antitrust restrictions.

In situations where they can be sustained, like those in S1 and S2, the formation of trust structures results in a lower federal income tax bill. Naturally, these structures only make sense if the income tax savings offset related costs. In all likelihood, the tax savings would outweigh administrative costs relating to the establishment and maintenance of the trust. The potentially more significant costs, however, relate to the tax implications of the actual formation and funding of the trusts.

VI. Tax Implications of Forming and Funding Trust

When property is transferred from one taxpayer to another, a potentially taxable event occurs absent a provision in the Code to the contrary. If the transfer constitutes a gift, federal gift tax may be imposed with respect to the transfer.[52] In the case of a non-gift disposition of property, the transferor may have income if the amount realized on the disposition exceeds the transferor's basis in the property.[53]

A gift results from any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed.[54] However, the gift tax is imposed only on gift transfers made by individuals and it does not apply to a transfer of intangible property by a non-U.S. domiciliary who is not a U.S. citizen or expatriate.[55] Although gift tax is not imposed with respect to transfers by a

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52 Section 2501.
53 Section 1001.
54 Treas. Reg. §25.2511-1(c)(1).
55 Section 2501(a)(1) and (2); and Treas. Reg. §25.2511-3.

corporation or other entity, the regulations indicate that any gift made by a corporation will be considered to be a gift to the transferee from the shareholders of the corporation.[56]

No gift results if property is transferred for adequate and full consideration in money or money's worth.[57] A transfer of property that is "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."[58] Whether property is transferred as a gift or for full and adequate consideration, if the transferee takes the property subject to debt or otherwise assumes debt of the transferor in connection with the transfer, the transferor will realize taxable gain to the extent that the assumed debt plus other consideration received exceeds the transferor's basis in the property.[59]

When property is transferred to a trust by gift, the trust's basis in the property is generally the same as that of the grantor of the trust increased by the amount of gift tax paid.[60] If property is acquired by a transfer in trust, other than by a transfer by gift, the basis of the property is the same as it was in the hands of the grantor increased by gain or decreased by loss to the grantor on such transfer.[61] A trust's holding period for property transferred to it includes the grantor's holding period in such property.[62]

As these rules are applied to S1 and S2, the formation and funding of AT and PT should not trigger any federal tax liability. In the case of AT (S1), the transfer of the

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56 *See*, Treas. Reg. §25.2511-1(h)(1).
57 Section 2512(b).
58 Treas. Reg. §25.2512-8.
59 *See*, Section 1001 and Treas. Reg. §§1.1001-2(a)(1) and (4).
60 Sections 1015(a) and (c).
61 Section 1015(b), Treas. Reg. §1.1015-2.
62 Section 1223(2).

investment assets by A to AT would constitute a gift to the beneficiaries of AT.[63] Because A is a nonresident alien and assuming he were a nondomiciliary, U.S. gift tax would not be imposed with respect to the transfer.[64] Neither AT nor its beneficiaries would realize income from the transfer since gross income does not include amounts received as gifts.[65]

The consequences of the transfer from P to PT (S2) are less obvious than those of the transfer from A to AT. P does not actually receive anything from PT in exchange for the transfer of U shares to PT, so the transfer does not appear to be a transaction for which Section 1001 governing gain or loss from the sale or other disposition of assets would trigger gain.[66] Although it seems odd to consider the gift tax rules in the corporate context since one does not think of corporations making gifts, an analysis is necessary to show that, in fact, P would not be considered to have made a gift in this context. As noted above, the regulations indicate that any gift by a corporation is considered to be a gift by its shareholders.[67] Thus, if the transfer from P to PT were a gift, PT's shareholders could be treated as having made the transfer. Whether such a transfer would be subject to gift tax depends on whether there were adequate consideration received therefor. Although P did not receive consideration for purposes of Section 1001, P should be treated as receiving full and adequate consideration for the transfer for purposes of the gift tax: As long as PT has a business purpose for the transfer and because it was made in

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63 Helvering v. Hutchings, 312 U.S. 393 (1941) (A gift transfer to a trust constitutes a gift to the beneficiaries rather than to the trust entity.).

64 We have assumed that A is not an expatriate.

65 Section 102(a).

66 *See* Abegg v. Commissioner, 50 T.C. 145 (1968), *aff'd* 429 F.2d 1209 (2d Cir. 1970), *cert. den.* 400 U.S. 1008 (1971). *Cf.* Sections 367(c), 684, 336(a) and 897(d). However, if liabilities of P relating to U's business were assumed by PT in connection with the transfer, P would be treated as receiving consideration from PT equal to the amount assumed and would recognize gain on the transfer of U stock to the extent such assumed liabilities exceeded P's basis in U shares.

the corporate context, PT should be able to treat the transfer as one made in the ordinary course of business for purposes of Treas. Reg. §25.2512-8. As such, the transfer would be treated as having been made for full and adequate consideration and could not be treated as a gift transfer.

Although the transfer itself should not trigger any federal tax liabilities to P, the collateral tax effects of the transfer and the future tax implications with respect to the trust structure warrant discussion. If P filed a consolidated tax return in which U were included, the transfer of the U shares to PT would cause U no longer to be a member of the affiliated group since indirect or constructive ownership is not taken into account for purposes of Section 1504. Thus, U's items of income or loss would no longer be taken into account within the P group and the departure of U from the affiliated group could trigger the recognition of existing deferred intercompany items.

Additionally, if U made dividend distributions after the transfer to PT, those dividends (as reduced by the 70% dividends received deduction) would, as shown in Example 2A, be taxable to W at a 35% rate if they were currently distributed by PT. Such distributions would not have been taxable to P if it had not transferred U stock to PT because dividend income would generally have been eliminated in the consolidated return context or offset by the 100% dividends received deduction outside a consolidated return.[68]

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[67] *Supra*, n. 56

[68] Treas. Reg. §1.1502-13(f)(2) and Section 243(a)(3).

As noted above, U stock is not being transferred to W, but rather to PT for the benefit of W within the absolute discretion of PT trustees. If U stock were transferred to W, such transfer would fall within Section 351. The question arises whether a transfer to PT for the benefit of W would be treated as falling within Section 351.[69] It is possible that the value of W's interest in PT should be treated as a contribution by P to the capital of W. Since the interest is discretionary, it is unclear how, if at all, the interest could be valued. Valuing such an interest would be an even more difficult proposition if P had subsidiaries W1 and W2, both of which were given discretionary interests in PT.

Value aside, if the transaction were treated as a capital contribution to W, Section 351 would be implicated. In this case, under the applicable rules, P's basis in W shares should be increased by the basis of the U shares and W should obtain a basis in U shares equal to P's basis in such shares.[70] Significantly, however, if P were viewed as making a contribution of U to W, and since the U shares would reside in PT, one might argue that W would be deemed to make the transfer to PT. Were that to be the outcome, PT would be a grantor trust and W its sole grantor – in short, there would be no tax savings. In that connection, as noted earlier, regulations and certain rulings provide that a transfer of property by a corporation to a trust for the benefit of its shareholders is treated as a distribution to such shareholders and a contribution by them to the trust.[71] Moreover, the regulations and certain rulings seem to assume that all proceeds realized by the trust would be immediately payable to the beneficiaries who would have a say in the

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69 *Cf.* Treas. Reg. §1.83-6(d).

70 Sections 358 and 362.

71 Treas. Reg. §1.671-2(e)(4); Rev. Rul. 72-137, 72-1 C.B. 100; Priv. Ltr. Rul. 200203034 (Oct. 18, 2002); Priv. Ltr. Rul. 8412003 (May 19, 1982); G.C.M. 38791 (Aug. 28, 1981). *But cf.* Priv. Ltr. Rul 200127012 (Jul. 6, 2001) and Priv. Ltr. Rul. 9824014 (Mar. 10, 1998 (transfer of funds by Alaska Native Corporations to settlement trusts of which shareholders were beneficiaries resulted in the distribution of an economic benefit to shareholders, but corporation treated as trust grantor).

management and disposition of assets.[72] Then, it would seem that such trusts may not qualify as trusts. We will assume that whatever the result under Section 351, P would not be considered to have made a transfer to W followed by a transfer by W to the trust. On the basis of this assumption, our analysis proceeds.

Assuming P is not considered to have transferred the U shares to W, upon the creation and funding of PT, PT would succeed to P's basis and holding period in the U shares.[73] If the trustees of PT did in fact later sell the U shares and distribute trust assets to W in a subsequent year, the income tax results to PT and W would be as explained in Examples 2B and 2C. Returning to the facts of such examples, recall that W received a distribution from PT in Y3 of $20,000, comprised of $18,500 of after-tax proceeds from the sale of U shares and $1,500 interest. Assuming W distributed such amounts to P and P wished to distribute all or some portion of the proceeds to its shareholders, what would be the tax treatment of such distributions?

If P and W did not file a consolidated income tax return, the treatment of the distribution in P's hands would be determined under Sections 316 and 301 (dividend to extent of W's current and accumulated earnings and profits ("E&P"), return of capital to extent of P's basis in W shares and capital gain thereafter). W's E&P would include not only its $1,500 of interest income, but also the $18,500 distribution since it would increase W's surplus.[74] Thus, a distribution of any portion of the sales proceeds from W

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72 Priv. Ltr. Rul. 200203034 (Oct. 18, 2002).
73 Sections 1015(b) and 1223(2).
74 Treas. Reg. §1.312-6.

to P would be treated as a dividend assuming W made no other distributions to P in that year. Because P owns all of the stock of W, P would generally be entitled to receive a deduction for 100% of the amount of the dividend under Section 243(a)(3). Although P would not pay income tax on the dividend distribution as a result of the deduction, the dividend amount would still be included in P's E&P and could cause the distribution of sales proceeds by P to its shareholders to be taxed as dividends in the shareholders' hands.

The tax result of distributing a portion of the sales proceeds up the chain is essentially the same in the consolidated return context, although the concepts and terminology differ. In the case of intercompany nonliquidating distributions, the distribution (the full amount regardless of treatment under Sections 316 and 301) is not included in the recipient's gross income provided that there is a corresponding reduction to the basis of the distributing member's stock under the consolidated return basis adjustment rules.[75] To the extent a distribution exceeds basis, an "excess loss account" is created which can result in later recognition of income.[76] In general, positive adjustments to a subsidiary's stock in a consolidated group are made for taxable and tax-exempt income of the subsidiary and negative adjustments are made for the subsidiary's losses, non-capital, nondeductible expenses and distributions under Section 301 regardless of whether they are made from E&P.[77]

Returning to the facts of Example 2C, if P and W filed a consolidated return, P would have increased its basis in W stock in Y3 by the full amount of the distribution W

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75 Treas. Reg. §1.1502-13(f)(2).
76 Treas. Reg. §1.1502-19.
77 Treas. Reg. §1.1502-32.

received from PT ($1,500 taxable income and $18,500 tax-exempt income).[78] A distribution by W to P of sales proceeds would have reduced this basis, but would not have been taxable to P. If P then distributed the sales proceeds to its shareholders, they would be taxed on such distribution under the rules of Sections 316 and 301. In determining the portion of the distribution that would be treated as a dividend to P shareholders, W's E&P from the PT distribution will be "tiered-up" to P and treated as E&P of P.[79]

If instead of selling the U shares, the trustees of PT later determined that it was best to keep U within the corporate structure, PT could simply distribute the shares of U to W. Unless PT had income in the year such distribution were made, W would not have taxable income from the distribution and would take a carryover basis and holding period in the U shares. In this case, a tax-free spin-off of the U shares to P stockholders under Section 355 should still be available.[80]

The formation and funding of the trusts used in structures like those described in S1 and S2 may have some collateral tax consequences (particularly in the case of S2), but should not trigger federal gift or income taxes. However, where a new entity is

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78 W's tax-exempt income for this purpose includes "income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets (or an equivalent amount)." Treas. Reg. §1.1502-32(b)(3)(ii). Amounts equivalent to basis include money. Treas. Reg. §1.1502-32(b)(3)(iv)(B).

79 Treas. Reg. §1.1502-33(b).

80 A discussion of all requirements under Section 355 is beyond the scope of this article. However, assuming that all other Section 355 requirements are met, the acquisition of U stock by W from PT and then by P from W within 5 years prior to the spin-off distribution, should not cause the transaction to be taxable as a result of either Section 355(a)(3)(B) (boot) or Section 355(b)(2)(D) (active trade or business requirement). Both of these provisions disregard an acquisition of stock of the spun-off company within 5 years of the spin-off if no gain was recognized on such acquisition. Where W and P file a consolidated return, intercompany acquisitions are generally disregarded for this purpose. *See* Treas. Reg. §1.355-2(g)(1). If W and P do not file a consolidated return, back-to-back spin-offs could be possible since W would receive the U shares from PT in a tax-free distribution.

introduced with the result being a lower overall federal income tax bill, the Service may look for other avenues to attack the structure.

VII. Possible IRS Challenges

In the case of S1, it seems unlikely that the Service would attempt to challenge the structure. Trusts are most typically used in the family context such as this and B, C and D are the natural objects of A's bounty. Moreover, there may be no good policy justification for imposing a 30% rate on the U.S.-source gross income of nonresidents with respect to income that would be taxed to residents at a rate of 15%. If the motivations behind reducing the tax rate on dividends to 15% were to spur investment and/or eliminate a layer of double taxation, it would not make sense to apply the higher rate to nonresident investors.

Prior to the Foreign Investors Tax Act of 1966 (the "1966 Act"),[81] nonresident aliens earning above a threshold amount were taxed on their U.S.-source net income at the graduated rates applicable to residents. The 1966 Act removed that rule and imposed the current 30% flat tax on gross income without deductions for certain U.S.-source income. The legislative history of the 1966 Act states that since nonresidents are not allowed deductions, 30% was considered an "appropriate" rate and that "[i]t is also thought that applying the uniform flat rate . . . would tend to encourage investments here by foreigners."[82] Since the 30% tax rate on U.S. source non-effectively connected dividends earned by nonresident aliens and foreign corporations, applicable in the absence of a lower rate prescribed by an applicable tax treaty provision, is now higher

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81 P.L. 89-809.

82 Senate Report No. 1707. 1966-1 C.B. 1055 at 1075.

than that imposed on a resident, it is doubtful that with respect to dividend income, the 30% rate is "appropriate" or would encourage investment in the United States.[83]

Not only are the parties in a situation like that in S1 on sound legal footing, but the Service also may not have an incentive to challenge the structure. Thus, a nonresident alien in a position like A in S1 should be able to establish a trust along the lines of that in S1 without concerns of a successful challenge by the Service.

However, a situation like S2 is far more likely to attract attention. The use of a trust within the corporate context is unusual on its own, but where it results in capital gains being taxed at the lower individual capital gains rates rather than at the regular corporate rates, rest assured that the Service will take notice and umbrage. The following text discusses several possible attacks the Service might make on a situation like S2.

As a starting point, the necessity for a plausible business purpose for the transfer of shares to the trust must be reiterated. Without a business purpose, the actual transfer could be treated as a transfer to P's shareholders and would certainly be more vulnerable to an attack that the transaction should be disregarded because it lacked economic substance or, worse still, triggered a Section 311 gain.

This structure should also only be used by entities with some patience. As already discussed, in order to achieve the intended tax results, the sale of U stock by PT and the distributions of sales proceeds by UT must occur in different tax years. On a more basic level, it would probably be inadvisable for PT to sell the shares of U shortly after they are transferred by P to PT. Although there is authority in the trust context indicating otherwise, a sale shortly after the transfer might be attacked under a pure

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[83] Cf. Article 10(3) of the U.K.-U.S. Income Tax Treaty; Article II of the 2002 Protocol to the Mexico-U.S. Income Tax Treaty.

substance over form argument, *i.e.*, if the sale occurs shortly after P transfers the U shares to PT, P might be treated as though it actually sold the shares and then transferred the proceeds to PT.[84] Under this same reasoning, the trust structure should probably not be employed where prior to the transfer to PT, P has already been involved in discussions with a third party about the sale of U and eventually PT sells the U stock to that third party.[85]

Even where there were no evidence that P already intended to sell U stock to the ultimate purchaser and PT held the U stock for a meaningful period before selling it, the Service might try to apply the step transaction doctrine to tax the capital gain from the sale of U shares at rates applicable to corporations. Their argument might be that when the completed transaction is viewed in its entirety, the sales proceeds end up in the hands of a corporation and thus the gain related to those proceeds should be taxed as if earned by that corporation. Without going into a detailed discussion of the step transaction doctrine, it is difficult to imagine how this argument could succeed where PT has independent trustees since nothing about the "steps" of the transaction involving the trust could be too thin or artificial.[86] After U shares are transferred to PT, the trustees may ultimately determine that selling the shares is not appropriate and, in any event, they would determine the timing and terms of such a disposition. Additionally, even after the sale, the timing of the distribution of the sales proceeds is within the discretion of the trustees.

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84 *Cf.* Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971); Court Holding, *supra*; National Securities Corp., *supra*; and McDonalds Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

85 *Id.*

86 For a discussion of the step transaction doctrine, *see* Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶4.3.5 (3d ed. 1999).

Because P owns 100% of the stock of W, it is conceivable that the Service would attempt to treat P as a beneficiary of PT, arguing that the relationship indirectly makes P a beneficiary of PT. If in addition to being the grantor of PT, P were treated as a beneficiary, PT would be a grantor trust and P would be treated as directly owning U stock held by the trust. If PT later sold the U stock, P would be treated as having directly made the sale and realized the gain. We note that even in the family context such as S1, the grantor of a trust indirectly benefits from granting beneficial trust interests to his children in that he may no longer be required to directly give funds to his children. Yet, the grantor trust rules do not operate to treat beneficial interests given to children as retained by the parent grantor. Of course, in the family context, the parent does not have the type of legal control over a child whereby he could require a child to relinquish trust distributions. In the corporate context, P, though its ownership of W, could cause distributions received by W from PT to be further distributed up to P.

The more significant flaw with the indirect beneficiary argument, though, is that it essentially requires the separate existence of W to be disregarded. The grantor trust rules specify the situations in which a grantor will be treated as the owner of trust assets and ownership of interests in a trust beneficiary is not such a situation. As a general rule, the separate corporate existence of related entities cannot be disregarded absent specific statutory provisions to the contrary or unless the entity is a sham.[87] For example, without the specific provisions of Sections 355(b) or 1297(c) which treat a parent corporation as operating the business and owning the assets of its subsidiary, the parent would be treated as owning only the stock of the subsidiary. Even in the consolidated return context,

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[87] *See, e.g.*, Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

corporations in the affiliated group are treated as separate entities with separate income calculations made for each entity in the group. Thus, as a general matter, P could not simply be treated as owning interests held by W unless W were a sham. As a pre-existing entity with an operating business, W clearly would not be a sham entity. Accordingly, the Service should not be able to treat P as a beneficiary of PT.

Nor should the Service be able to disregard the existence of PT as a separate trust entity on the theory that the trust is a sham. Although there is authority for treating trusts as sham entities, these typically involve family situations where trust formalities are disregarded.[88] Where a trust has independent trustees, trust formalities are observed and a business purpose exists for trust formation, it is highly improbable that the Service would make and even less likely it could win a sham trust argument.[89] In addition, the Service should not be able to invoke Section 482 to reallocate income between a trust with independent trustees and the grantor of such trust because an independently managed trust would not be controlled by the same interests as the grantor.[90]

As noted above, in a different spin on the grantor trust argument, the Service might treat W as not only the beneficiary of PT, but also as the grantor by arguing that in substance P made a capital contribution of U shares to W and W transferred them to PT. Presumably the same could be said in the family context, *i.e.*, that a father who is grantor of a trust for his children really gave trust corpus to the children who transferred it to the trust, thereby treating virtually any trust as a grantor trust. Obviously, that result was not

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88 *See, e.g.,* Markosian v. Commissioner, 73 T.C. 1235 (1980); Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984); Notice 97-24, 1997-1 C.B. 409.

89 *See, e.g.,* Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983); May v. Commissioner, 723 F.2d 1434 (9th Cir. 1984); and Evans v. U.S., 572 F.Supp. 74 (C.D. Ill. 1983) (trusts established with independent trustees could not be disregarded as shams in gift-leaseback transactions).

90 Evans, *supra.*

intended, but the Service might point to the grantor trust regulations for support of this treatment in the corporate context.

Treas. Reg. §1.671-2(e)(4) provides that if a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the corporation but is for the personal purposes of one or more of the shareholders, the transfer will be treated as a constructive distribution to the shareholders and they will be treated as the grantors of the trust. The Service might argue that in the corporate context an analogous rule should apply so that transfers made to a trust by a parent corporation for the benefit of a subsidiary should be treated as a constructive contribution to the subsidiary with the subsidiary treated as the grantor of the trust. It is not apparent that such an analogy would be appropriate, particularly in the case of a discretionary trust. In S2, it would not be clear at the time of transfer exactly what W might receive and when. Moreover, the application of such an argument would be even more unworkable if a trust had more than one discretionary beneficiary. For example, suppose P had subsidiaries W1 and W2 that were both made beneficiaries of PT. Since distributions to and between W1 and W2 would be entirely discretionary, which subsidiary should be treated as a grantor, and if both should, in what proportions?

Even if such an analogy were proper, under the exception to the regulatory rule, if the transfer were made for a business purpose of the parent corporation it should not be treated as a constructive contribution to the subsidiary. We have already discussed that, as a basic requirement, P would need to have a business purpose for creating PT. Consequently, the Service should not be able to treat W as both the beneficiary and grantor of PT under this type of argument.

VIII. Conclusion

The winds of change have brought the world of "ordinary" trusts, which are typically the milieu of wealth management planners, into a collision course with corporate and personal income tax planners. In practice, these two worlds rarely cross paths, but if they do, we have seen that beneficial structures can emerge. The use of a trust structure to effectively reduce U.S. income taxation on U.S.-source dividend income paid to nonresidents may be practical and appealing for wealthy off-shore, non-treaty country resident individuals with significant U.S. investments. That such a structure appears to be low-risk from a tax perspective only strengthens its appeal.

More exciting though is the idea that corporations may be able to implement trust structures to cause capital gains to be taxed at the rates applicable under Section 1(h) rather than the regular corporate rates. The trust structure in the corporate context may also have applications in other situations beyond that explored in this article where ownership by a corporation results in less favorable tax treatment than ownership by a trust taxed as an individual. That the Service may be equally excited (albeit less enthusiastic) about this structure, however, may dampen our enthusiasm. Whereas it seems unlikely that the Service would challenge the trust structure employed by a nonresident alien individual, the same cannot be said for the corporate trust structure. Historically, the Service has never fancied taxpayers' use of new entities to reduce taxes and in a case where the income tax bill stands to be reduced by more than half, a charge (in all senses of the word) is more likely than a white flag.

If a corporation has a valid business purpose for establishing the trust structure, the chance of a successful challenge by the Service is reduced significantly. This paper

has suggested that there may well be situations in which it would be advisable to transfer shares to a trust to accomplish a business objective. In such cases, the tax savings may be frosting on the cake. The scarcity of such situations combined with possible business impracticalities of implementing a trust structure that would stand up to a challenge by the Service may transmute the trust structure to mere fantasy for most corporate taxpayers, but it certainly is a nice fantasy.