

# **Substance & Form in US Planning for Global Clients**

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# **Substance & Form**

Tax liability follows income in the case of income tax and location (“situs”) of taxpayer’s estate or gift in case of estate/gift tax

Income and location are derived from economic event or nexus

# **Substance Over Form as Basis for Taxation**

Given that tax follows economic “substance” – i.e., results separate from tax results – doctrine permits “realignment” of reported results to conform to the “substance” of a transaction.

# 01

Is this a “Sham” in Fact?

- E.g., change in title but not control

# 02

Is this a “Sham” in “Substance”?

- Transaction has no “economic impact” other than tax reduction/avoidance

# 03

Are we seeing the Whole Picture?

- If reorder the steps, what do we see?
- Do the steps have independent substance?

## Fundamental Questions

Collapses "formally distinct steps in integrated transaction" in order to assess federal tax liability on the basis of a "realistic view of the entire transaction."

As such, the doctrine is part of the "broader tax concept that substance should prevail over form."

## **"Step-transaction" doctrine**

1

Non-US father owns  
real estate in US

2

Father sells real  
estate to son on  
installment method  
(i.e., promissory  
note)

3

Source of son's  
"down payment" is  
cash transferred by  
father

4

Father transfers  
cash to son going  
forward to make  
installments

# Step Transaction Doctrine at Work

Court concludes that transaction is part sale and part gift by father

- taxable gift of US real estate



Court finds that initial cash transfer for down payment was actually a “gift” equal to that portion of the real estate

- Gift of cash for down payment was “conditioned” upon its use for the purchase

*Davies v. Commissioner*

**Step Ignored as without  
Purpose = Adverse Result**

Doctrines are bound by, and in some tension with, the principle, equally lauded in tax law, that "anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury."

Different "forms" are appropriate and have attendant tax consequence.

Taxpayers are free to choose the manner in which they operate

# "Form" as "Substance"



# **“Form” as “Substance” for Non-US Persons**

Transfer at death of shares in US domestic companies (including US mutual funds, ETFs) is subject to US estate tax

Transfers at death of shares in non-US company holding shares in domestic corporations is not subject to US estate tax

Transfers of shares of US domestic corporations is not subject to US gift tax



Congress has recognized distinctions between “indirect” and “direct” ownership and permitted “indirect” ownership to continue

Underlying investment companies understood to operate as “blockers” for US estate tax exposure for Non-US persons provided company administration is maintained

**Form “becomes” Substance**

# Form = Substance

Non-U.S.  
Settlor is Beneficiary

Foreign  
Trust

US Situs Assets  
e.g., shares in Apple,  
Alphabet, Facebook

Non-U.S.  
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Non-U.S.  
Corporation

US Situs Assets  
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# Form Taints Substance - Forever

**Non-U.S. Settlor  
Contributes US Situs  
Assets to Trust of  
which beneficiary**

US Situs Assets

Foreign  
Trust

**20 Years  
later –  
Settlor dies**

Non-U.S.  
Settlor/Beneficiary

Foreign  
Trust

Non-U.S.  
Corporation

US Situs Assets  
e.g., shares in Apple,  
Alphabet, Facebook

# Tainted Substance with Long Lasting Results

Even though - as of date of death - trust owned no US assets, settlor subject to US estate tax

Only alternatives are for Settlor to relinquish beneficiary status during life or start over

- Portion of US contributions relative to non-US situs contributions deemed taxable in US
- “Tracing” construct
- Based upon values

# **Form Ignored & Substance Enforced**



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# Indirect Transfers from Foreign “Intermediary”

Indirect transfers to US person via third parties other than trust grantor

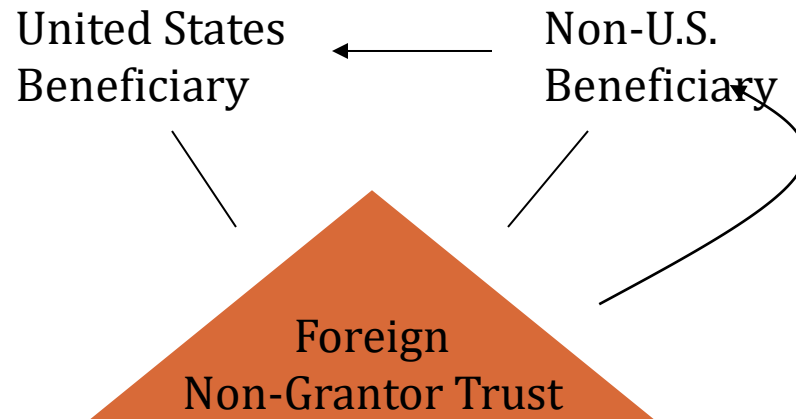
If third party received property from trust and transferred that property to US person, US person may be deemed to have received distribution from trust.

“Property” can include cash, or proceeds of distributed assets



# Distribution to U.S. Beneficiary via Non-U.S. Beneficiary

- Distribution of FT property (e.g., cash) from FT to Non-U.S. Beneficiary
- Non-US Beneficiary Makes “Gift” to US Beneficiary





01

Is US person related to/have relationship with grantor of trust sufficient to establish a “gratuitous transfer” by grantor?

02

Collapses transfers from trust to intermediary or intermediary to US person occurring within a 48 month period, and

03

Can US person show that intermediary related to US person, acted independently, and is not an agent under agency principles?

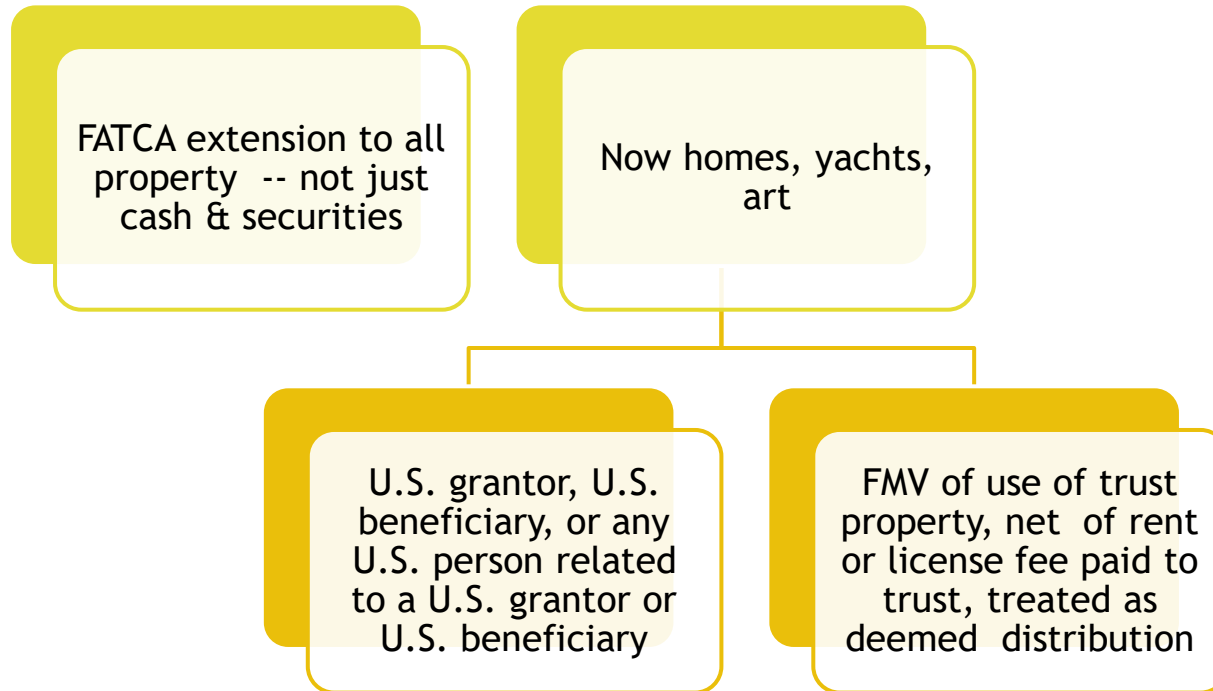
04

Did US person comply with reporting obligations?

# Presumption of Tax Avoidance

- ▶ Loans by foreign trust to U.S. grantor, beneficiary or related person treated as distribution - section 643(i)
  - ▶ Loan repayment ignored
  - ▶ Exception for “qualified obligations”
    - ▶ Documented
    - ▶ U.S. dollar-denominated
    - ▶ Interest rate 100 to 130% of applicable Federal rate
    - ▶ Maximum five year term
    - ▶ Form 3520 reporting and statute waiver if loan not repaid

## Constructive Distributions



# Uncompensated Use of Trust Property

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Note that distribution not taxable if the trust has neither DNI nor UNI

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First from DNI, then from UNI?

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What if there is neither, e.g., trust only owns non-income producing assets?

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Can income be imputed

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# Uncompensated Use of Trust Property



# Use of Corporate Property

## Imputed Income/Indirect Trust Distribution

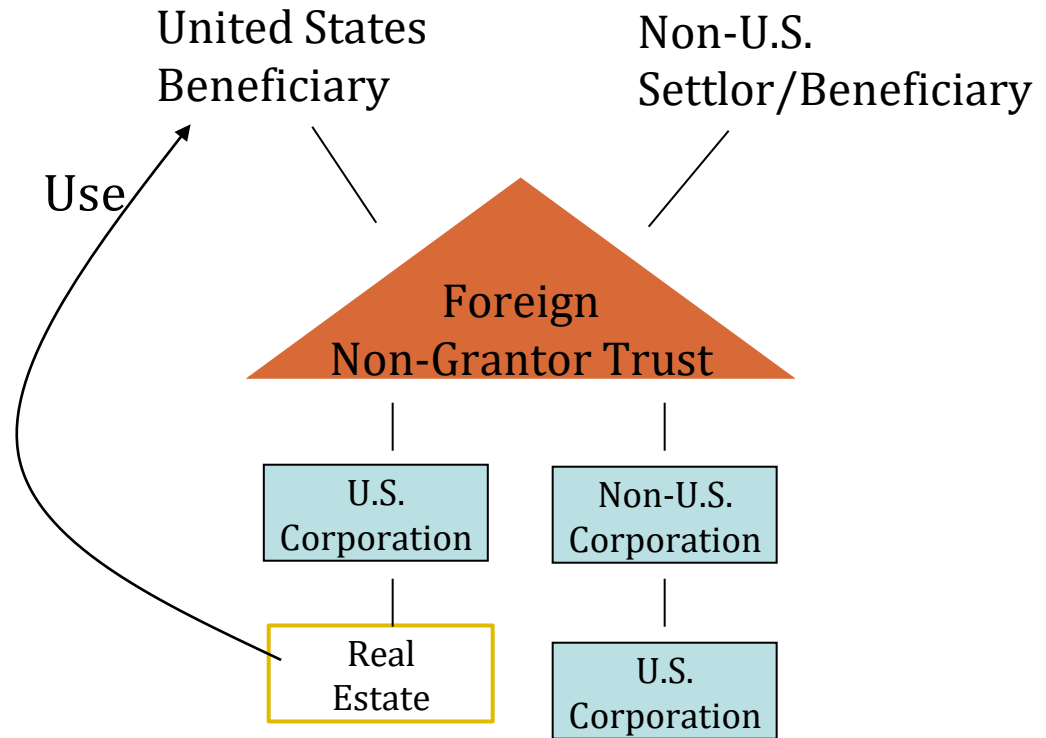
US Corporation imputed income equal to rental value of home

Non-US trust subject to tax at rate equal to 30% of imputed rent

US corporation required to withhold 30%

US beneficiary has income equal to rent as well

US Beneficiary uses real estate owned by US corporation owned by Foreign Trust



Change the  
“Form” But Not  
the “Substance”

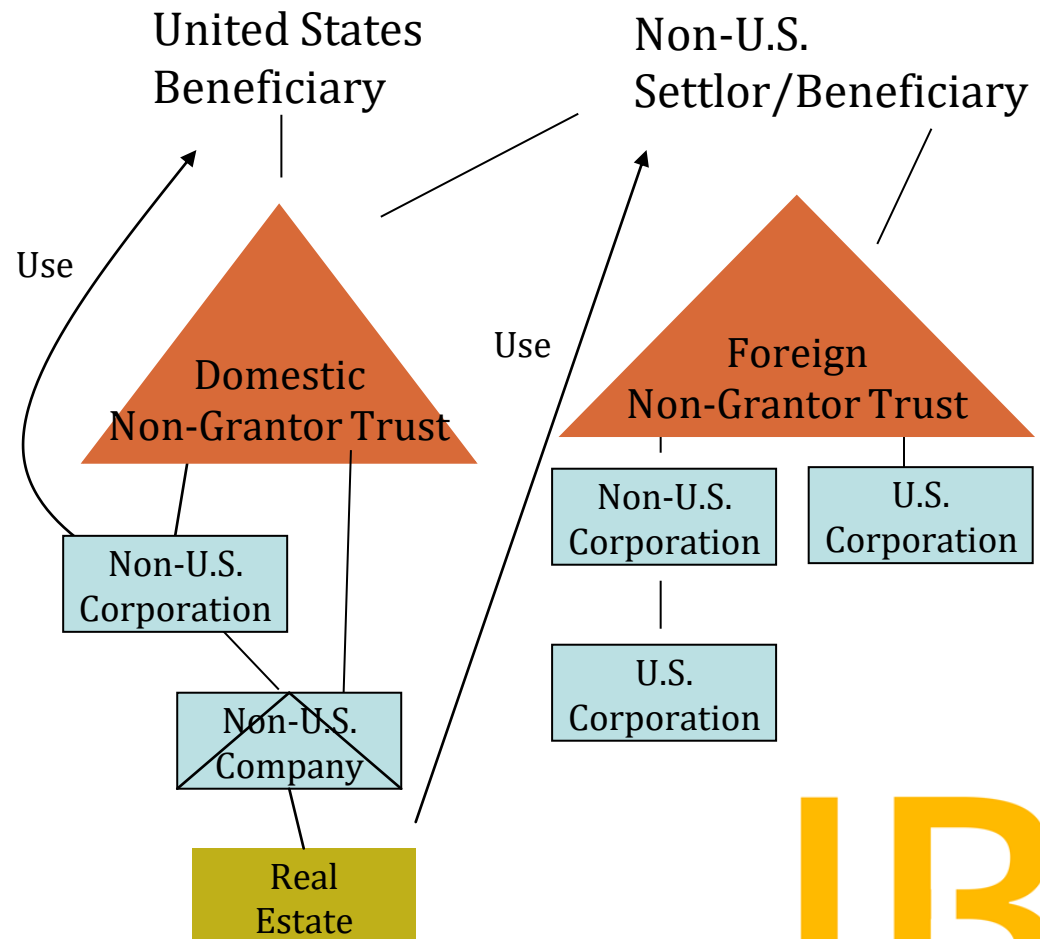
# Use of Property of Domestic Trust

## No Imputed Income/Trust Distribution

**Only difference is largely one of “form”**

Instead of ownership by corporate entity and use by US person, a “checked” entity owns the property where that checked entity acts as estate tax blocker for Non-US Settlor/beneficiary

Use of a property by a US beneficiary of a domestic trust does **not** give rise to a deemed distribution and (likely) no imputed income where the entities are not in business

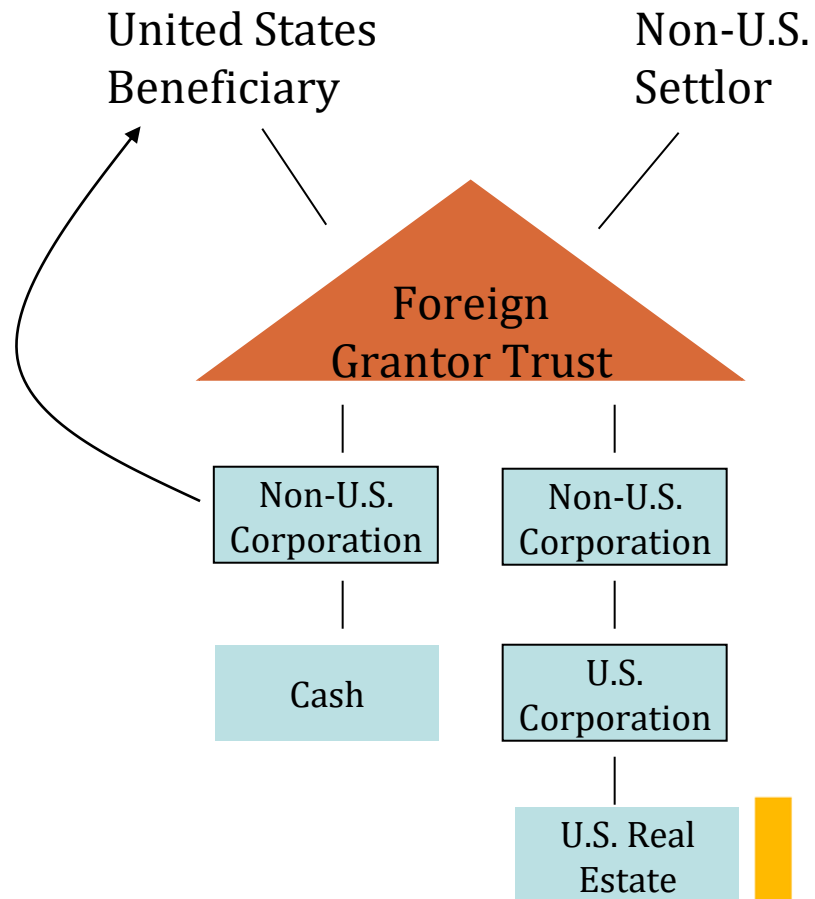


# Corporations Don't Make Gifts



# Distribution from Non-U.S. Corporation: Indirect Trust Distribution or Corporate Gift?

- Distribution of Cash from FT owned Non-U.S. corporation to U.S. Beneficiary
- Whether to report as distribution on Part III of Form 3520 as distribution from a foreign trust, as may be indirect distribution from FT?
- Or, is it a gift from a Non-U.S. corporation?
- If gift, taxable as ordinary income to U.S. Beneficiary to extent of earnings & profits of corporation, and thereafter capital gain (Section 1.672(f)-4)
- Issues arises on distribution if corporation is a PFIC, likely the case only if FT is a “nongrantor” trust



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