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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B02- PLR-128894-00

Date:

April 3, 2001

Trust 1 =

Trust 2 =

Corporation =

m =

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Date A =

Location L =

Dear :

This letter responds to your letter dated November 10, 2000, and subsequent correspondence, written on behalf of Corporation and Trust 2, requesting rulings on several issues arising from the establishment, funding and potential termination of Trust 2.

BACKGROUND

In 1971, the Alaska Native Claims Settlement Act of 1971 (ANCSA), Pub. L. No. 92-203, 85 Stat. 688, 43 U.S.C. §§ 1601 et. seq., settled the Alaska natives' claims to land and resources. Under the ANCSA, corporations established by qualified Alaska natives received certain assets. The ANCSA provided that all United States citizens with 1/4 or more of Alaska Indian, Eskimo, or Aleut blood, who were living on December 18, 1971, were qualified to participate in the settlement. The ANCSA implements the

PLR-128894-00

settlement of Alaska Natives' aboriginal land claims by providing for the conveyance of certain lands and money (Alaska Native Fund, or "ANF") to the Native Corporations as compensation. The Alaska Natives who qualified were allowed to enroll as stockholders and receive stock in one of the twelve regional corporations and in one local village corporation created under the Act to receive assets.

The ANCSA, as enacted in 1971, provides that for a period of 20 years after December 18, 1971, the stock, inchoate rights thereto, and any dividends paid or distributions made with respect thereto may not be sold, pledged, subjected to a lien or judgment execution, assigned in present or future, or otherwise alienated. This limitation, however, does not apply to transfers of stock pursuant to a court decree of separation, divorce or child support; by a stockholder who is a member of a professional organization, association, or board which limits the ability of that stockholder to practice his profession because of holding such stock; or by inter vivos gift to certain family members. The ANCSA also provides that upon the death of any stockholder, ownership of such stock shall be transferred to any person in accordance with his last will and testament or under the applicable laws of intestacy, except that during the 20-year period after December 18, 1971, such stock shall carry voting rights only if the holder thereof through inheritance is also an Alaska native.

Subsequent amendments to the ANCSA generally extend beyond December 18, 1991, the alienability restrictions on the settlement common stock of an Alaska Native Corporation (ANC) unless and until the shareholders of the corporation decide to terminate them. 43 USC § 1629c. If the shareholders vote to terminate the alienation restrictions on the stock, all settlement common stock is canceled as a matter of law and is replaced with unrestricted replacement common stock. 43 USC § 1606(h)(3). Thereupon, the special character of the corporation as an ANC created under ANCSA ceases and the corporation becomes a regular domestic corporation subject to regulation under securities laws.

To accommodate the desire of certain ANCs to transfer a portion of their assets out of the corporate form, the Alaska Native Claims Settlement Act Amendments of 1987 authorizes the conveyance of certain assets of an ANC to a state-chartered settlement trust. The general purpose of the settlement trust is to preserve native heritage and culture and to promote the health, education, and economic welfare of its beneficiaries, the shareholders of the transferor ANC, and their lawful successors. The trust is to be used to insulate permanently land, as well as other assets transferred to it, from the business risks undertaken by the corporation. Such trusts may not operate as a business nor may they make a subsequent transfer of land or interests therein except for a reconveyance to the transferor corporation, if such reconveyance is authorized in the trust instrument. 43 USC § 1629e. ANCSA requires that the beneficiaries of a Settlement Trust (Beneficiaries) be the shareholders of the Native Corporation that establishes the Settlement Trust.

PLR-128894-00

If the board of directors of an ANC adopts a resolution to establish a settlement trust, the resolution to establish the trust must be submitted to a vote of the corporation's shareholders for approval. 43 USC § 1629b(a)(3) and § 1629b(b). The shareholders, however, are not required to approve the conveyance of any assets by the corporation to the trust unless all or substantially all of the assets of the corporation are to be conveyed. 43 USC § 1629e(a)(1)(B).

FACTS

The following facts have been represented.

Corporation is an ANC formed pursuant to the ANCSA and Alaska state law for the Alaska Natives residing in and around Location L. Pursuant to the above amendment to ANCSA, Corporation established a settlement trust (Trust 1) in 1997 to promote the health, education and welfare of its beneficiaries through Trust distributions and to preserve the trust principal needed to produce income for such distributions. Trust 1 was the subject of PLR 9824002 (February 27, 1998). Trust 1 is in operation and will begin making distributions in 2002.

Corporation now wishes to establish a second settlement trust, to provide long-term land protection for certain of Corporation's timberlands and to eventually provide pro rata distributions of the income generated from those timberlands to the approximately m shareholders of Corporation. Corporation's Board of Directors on Date A, approved the establishment of a shareholder Settlement Trust (Trust 2). As of Date A, \$x was transferred to Trust 2 and Trust 2 became effective under Alaska law. Corporation's Board of Directors intends to transfer certain timberlands to Trust 2. Corporation's Board of Directors has discretion to make future contributions of cash or other property to Trust 2 in years after the initial contribution.

The Trust agreement provides that the Beneficiaries of Trust 2 are the holders of Corporation's Settlement Common Stock. Each person who is a registered holder of the Settlement Common Stock of Corporation shall receive the same number of "Trust Units" as they hold shares of Corporation's Settlement Common Stock. There will be Class A and Class B Trust Units of Trust 2. Class A Trust Units will be issued to holders of Corporation's Settlement Common Stock which, in accordance with the Articles of Incorporation of Corporation, carries a right to vote for the Board of Directors of Corporation. Class B Trust Units shall be nonvoting units and shall be issued to holders of Corporation Settlement Common Stock which, in accordance with the Articles of Incorporation, does not carry a right to vote in elections for the Board of Directors of Corporation.

The Trust Units of Trust 2, like the Trust Units of Trust 1, cannot be transferred separately from Corporation's stock and thus are currently "stapled" to the stock. Valid transfers of Corporation's Settlement Common Stock, which can occur only in the

PLR-128894-00

limited circumstances provided for under § 7(h) of ANCSA, generally result in an automatic transfer of the corresponding Trust Units. If the Trust Units become "unstapled" from Corporation's stock, the Trust Units of Trust 2 will generally remain "stapled" to the Trust Units of Trust 1.

Except as otherwise provided, the Trustees of Trust 2 shall consist of those persons who are the duly elected or appointed members of the Board of Directors of Corporation. The affairs of Trust 2 shall be managed by the Trustees.

Trust 2 is irrevocable and the duration of Trust 2 is indefinite unless affirmative action is taken. Prior to January 1, 2040, the "Net Cash Income," as defined in the Trust Agreement, will be used first to maintain protection for the timberland, and thereafter, to enhance the long-term value of Trust 2's Real Property. Trust 2 Real Property means such timberlands (including without limitation, any standing or down timber thereon) which may be conveyed into Trust 2 pursuant to the Trust Agreement by Corporation. If Net Cash Income is available after these ongoing expenses, the Net Cash Income in the judgment of Trustees may either be retained within Trust 2 or distributed outright to Beneficiaries. Management anticipates there will be few if any distributions made prior to January 1, 2040. After January 1, 2040, the expectation is that significant value will be realized from the timber and that distributions will be made to the Beneficiaries. Distributions shall be pro rata based upon the number of Trust Units owned by each Beneficiary.

As required by ANCSA, Corporation's creditors at the time assets are transferred to Trust 2 can reach the Trust 2 assets in satisfaction of Corporation's debts only if adequate assets are not left in Corporation to satisfy those debts existing at the time of the transfer. 43 U.S.C. § 1629e(a)(1)(B)(3), § 1629e(c)(3), and § 1629e(c)(5). Those who become creditors of Corporation after assets are transferred to Trust 2 will not be able to reach Trust 2 assets. Corporation represents that at the time of any contribution to Trust 2, the assets retained by Corporation would be adequate to discharge Corporation's anticipated liabilities. Corporation further represents that the timberlands that will initially be contributed to Trust 2 in 2001 will be unencumbered.

In general, once approved by Corporation's shareholders, Trust 2 cannot be modified. However, there are several exceptions to this. First, Corporation and Trustees could modify or terminate Trust 2 in order to obtain a favorable ruling from the Internal Revenue Service (but only before December 31, 2001). Second, following the affirmative vote of two-thirds of Trustees, a petition could be made to the Alaska state court in Ketchikan, and the Alaska state court could order necessary changes in the Trust Agreement or could terminate Trust 2. However, the only changes that could be made are those changes necessary to modify Trust 2 on account of a change that will have a "Material Adverse Effect" on Trust 2. Third, certain technical amendments may be made to Trust 2. These changes generally could not revoke Trust 2, change the Beneficiaries, cause Trust 2 assets to revert to Corporation or change the percentage

PLR-128894-00

of income used to provide benefits to Beneficiaries. Also, no modification could reduce the time between such votes on modification (including termination of Trust 2) to less than that indicated in the Trust Agreement.

Subject to the above provisions regarding termination, Trust 2 will continue forever unless termination action is taken. During the period January 1, 2040, through June 30, 2040, Trust 2 could be reviewed by a vote of Trustees and then by the holders of the Class A Trust Units. At least two-thirds of Trustees and the holders of two-thirds of the Class A Trust Units would have to vote for a change, as follows: (1) modify the percentage of income that may be used to provide benefits; (2) modify the percentage of principal that may be used to provide benefits; and (3) terminate Trust 2 and return all of Trust 2's Real Property to Corporation. Any other assets of Trust 2 would be distributed pro rata to the holders of Trust 2 Units. However, the reversion of Trust 2 Real Property to Corporation may only occur at such time so as to prevent Trust 2 from being a "Grantor Trust."

If Trust 2 is not terminated within the indicated period, Trust 2 would automatically continue another 10 years, at which point Trustees and the holders of the Class A Trust Units would make the same choices. Thereafter, the same decision process could occur (but need not) every 10 years.

Trust 2 is prohibited from making most loans, or from borrowing any amounts, guaranteeing any debt, or pledging Trust 2 assets in any manner.

LAW AND ANALYSIS

Under § 301.7701-4(a) of the Procedure and Administration Regulations, in general, an arrangement will be treated as a trust under the Internal Revenue Code if 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 business for profit.

Based on the facts and circumstances of this case, and in light of the Congressional purpose expressed in the governing federal statute concerning Settlement Trusts, Trust 2 is properly classified as a trust described in § 301.7701-4(a).

Section 671 of the Internal Revenue Code provides, in general, that if the grantor of a trust or another person is treated as the owner of any portion of the trust, that person's taxable income and credits shall include the income, deductions, and credits of the trust attributable to that portion of the trust to the extent that such items would be considered in computing the taxable income or credits of an individual.

PLR-128894-00

Sections 673 through 678 specify the circumstances under which the grantor or another person will be regarded as the owner of a portion of a trust. Based on our examination of the Trust Agreement, we conclude that neither Corporation, as the grantor of Trust 2, nor any other person will be treated as the owner of any portion of the Trust 2 under §§ 673, 674, 676, or 678.

Under § 675 and applicable regulations, the grantor is treated as the owner of any portion of a trust if under the terms of the trust agreement or circumstances attendant on its operation, administrative control is exercised primarily for the benefit of the grantor rather than the beneficiary of the trust.

Our examination of the Trust Agreement reveals none of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of the grantor under § 675. Thus, the circumstances attendant on the operation of Trust 2 will determine whether the grantor will be treated as the owner of any portion of Trust 2 under § 675. This is a question of fact, the determination of which must be made by the Office of the District Director with which the parties file their tax returns.

Section 677 provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as the owner under § 674, the income of which is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor, or held or accumulated for future distribution to the grantor without the approval or consent of any adverse party.

Under § 1.677(a)-1(d) of the Income Tax Regulations, the grantor shall be treated as the owner of the portion of a trust the income of which is, or in the discretion of the grantor or a nonadverse party may be, applied in the discharge of a legal obligation of the grantor.

Assets held by a settlement trust may not be used to satisfy the debts of an ANC unless those assets were encumbered before their conveyance to the trust, or their conveyance rendered the corporation insolvent or occurred when the corporation was insolvent. 43 USC § 1629e(c)(5). Corporation represents that retained corporate assets will be more than adequate to meet Corporation's obligations and that none of the assets that the Board of Directors has discussed contributing to Trust 2 would be subject to any lien or other liability at the time it is contributed to Trust 2.

Based on all the facts and circumstances, including Corporation's representations, Corporation, as the grantor, will not be treated as the owner of any portion of Trust 2 under § 677.

Section 661(a) provides that in any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B of part 1 of subchapter J of chapter 1 applies), the sum of (1) any

PLR-128894-00

amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and (2) any other amounts properly paid or credited or required to be distributed for such taxable year; but such deduction shall not exceed the distributable net income of the estate or trust.

Section 662(a) provides that subject to § 662(b), there shall be included in the gross income of a beneficiary to whom an amount specified in § 661(a) is paid, credited, or required to be distributed (by an estate or trust described in § 661), the sum of the following amounts: (1) the amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not; and (2) all other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.

Section 663(b) provides that (1) if within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year, and (2) § 663(b)(1) shall apply with respect to any taxable year of an estate or a trust only if the executor of such estate or the fiduciary of such trust (as the case may be) elects, in such manner and at such time as the Secretary prescribes by regulations, to have § 663(b)(1) apply for such taxable year.

Section 301(a) provides, in general, that a distribution of property made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in § 301(c). Under § 301(c)(1) and § 316, the distribution shall be taxable as a dividend to the extent of the earnings and profits of the distributing corporation.

Under § 301(c)(2), any amount which is not a dividend shall be applied against and reduce the distributee's adjusted stock basis. Under § 301(c)(3), any amount which is not a dividend and which is in excess of the distributee's stock basis shall be treated as gain from the sale or exchange of property.

The taxpayer has represented that there will be no actual receipt of the assets by the shareholders prior to the distributions made by Trust 2 pursuant to the Trust Agreement. Thus, the inquiry becomes whether funding Trust 2 provided or will provide the shareholders with either constructive receipt of the funds or an economic benefit that must be treated as a distribution from Corporation.

Section 1.451-2(a) provides that a taxpayer constructively receives income only when the income is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time. Conversely, income is not constructively received where the taxpayer's control over it is subject to substantial limitations or restrictions.

PLR-128894-00

In the instant case, the property to be transferred to Trust 2 will not be credited to any shareholder's account or set apart for the shareholder at the time of transfer from Corporation to Trust 2. No shareholder will have any right to demand payment ahead of the scheduled distributions. Moreover, no shareholder may assign Trust Units to a creditor, or attempt to create a security interest in the Trust Unit itself, in any underlying asset of Trust 2 or in any distribution (present or future) by Trust 2. Furthermore, a shareholder may not assign a Trust Unit apart from the related share of the Settlement Stock, which is itself restricted as to transfers. The shareholder's right to payment, moreover, is subject to claims of existing creditors of Corporation as provided by ANCSA. 43 §§ U.S.C. 1629e(a)(1)(B) and 1629e(c). Thus, the shareholders' control and ultimate receipt of the funds are subject to substantial limitations and restrictions. Accordingly, the shareholders are not in constructive receipt of the funds.

Nevertheless, if Corporation's shareholders derive some economic benefit from the transfers to Trust 2, such transfers may be treated as distributions to the shareholders. Under the economic benefit doctrine, a taxpayer has current income from an economic or financial benefit received even though it is not reduced to the taxpayer's immediate control. Sproull v. Commissioner, 16 T.C. 244 (1951); and Rev. Rul. 67-203, 1967-1 C.B. 105. Here, Trust 2 is subject to the claims of Corporation's existing creditors. 43 U.S.C. § 1629e(a)(1)(B) and § 1629e(c). However, the legislative history indicates that (i) the purpose of the Settlement Trust is to insulate assets from the business risks undertaken by Corporation¹ and (ii) creditors' rights are no greater than they would be under state law, *i.e.*, fraudulent conveyance law.

Thus, Corporation's creditors have no greater rights than the creditors in Sproull, *supra*. Accordingly, we conclude that the shareholders have received, and will receive, a currently taxable economic benefit, as of the dates of Corporation's transfers to Trust 2.

The shareholder's receipt of the deemed distribution is subject to treatment under § 301. Under ANCSA § 21(a), the shareholders' receipt of ANF proceeds is nontaxable, and accordingly, to the extent Corporation funds Trust 2 with ANF proceeds, the deemed distribution will be nontaxable but will reduce stock basis as under to § 301(c)(2). To the extent Corporation funds Trust 2 with cash or other property reflecting its earnings and profits (E&P), however, the funding will be taxable as a dividend under § 301(c)(1).

Moreover, transfers of non-cash property will be subject to § 311(b). Section 311(b) provides that if a corporation distributes property (other than an obligation of the corporation) to a shareholder in a distribution to which subpart A applies, and the fair market value of the property exceeds its adjusted basis (in the hands of the distributing

¹ S. Rep. No. 201, 100th Cong., 1st Sess. 35 (1987).

PLR-128894-00

corporation), then gain shall be recognized to the distributing corporation as if such property were sold to the distributee for its fair market value.

GCM 36720, I-376-74 (May 6, 1976) as modified (December 10, 1976), characterized the Government's transfer of ANF proceeds and land to the Native Corporations as payment to the Native shareholders who will be deemed to have immediately contributed the cash and land to the Native Corporations in exchange for Native Corporation stock in a transaction qualifying under § 351. The shareholders' basis in the stock is determined pursuant to § 358, which provides generally that the basis of the stock shall be the same as that of the property exchanged. In the case of land, the basis of the property exchanged, under ANCSA § 21(c), 43 U.S.C. § 1620(c), is the fair value of such property at the time of receipt from the Government, subject to certain modifications set forth in that section.

Accordingly, based solely on the facts presented and representations made in this ruling request, and viewed in light of the applicable law and regulations, we rule as follows:

1. Trust 2 is classified as a trust for federal tax purposes and not as an association or a partnership and is a separate entity for federal tax purposes.
2. Neither Corporation nor any other person shall be treated for tax purposes as the owner of Trust 2 or any portion of Trust 2 under §§ 671-678.
3. A currently taxable economic benefit will be conferred upon each of the shareholders of Corporation when cash or other assets (including ANCSA land) are transferred by Corporation to Trust 2.
4. The transfer of cash or other assets (including ANCSA land) by Corporation to Trust 2 shall be treated as distributions of such economic benefit by Corporation to the shareholders with respect to its stock within the meaning of § 301(a). The amount of the deemed distribution to each shareholder equals that beneficiary's interest in Trust 2 times the value of the cash and other property transferred to Trust 2.
5. Corporation's contributions to Trust 2 do not constitute gross income to Trust 2.
6. Corporation is not entitled to a deduction for the amounts contributed to Trust 2.
7. Trust 2's basis of any property transferred to it by Corporation will be the same as the basis of the property in the hands of Corporation immediately prior to the transfer, adjusted for any gain or loss recognized by Corporation. Section 1015(b).

PLR-128894-00

8. The holding period of any property transferred by Corporation to Trust 2 includes the period Corporation held such assets.

9. Any portion of the deemed distribution (described in Ruling 4 above) that is made from earnings and profits of Corporation will be treated as a dividend and shall reduce Corporation's earnings and profits. Sections 301(c)(1) and 312.

10. Any portion of the deemed distribution (described in Ruling 4 above) that is made from ANF proceeds or other non-earnings and profits sources will not be treated as a dividend or reduce earnings and profits, but will reduce the shareholder's stock basis and, to the extent of the excess over basis, will be treated as gain from the sale or exchange of property. Sections 301(c)(2) and (3). Any portion of the deemed distribution that reflects the transfer of land to Trust 2 will not be treated as made from ANF proceeds or other non-earnings and profits sources to the extent that Corporation has any earnings and profits at the time of the distribution. Sections 301(c)(1) and 316(a).

11. Corporation will recognize gain on the transaction under § 311(b) to the extent that the fair market value of any assets used to fund Trust 2 (including ANCSA land) exceeds Corporation's basis in the assets.

12. Corporation's shareholders will receive a basis in their respective beneficial interest or Trust Units (representing such beneficial interest) equal to the amount of each respective distribution (cash plus the fair market value of property transferred by Corporation to Trust 2) deemed to occur under ruling 4 above. Section 301(d).

13. The shareholder's basis in the stock of Corporation is equal to:

- a. The Native shareholder's ratable portion of ANF proceeds received by Corporation pursuant to ANCSA minus the amount of ANF proceeds transferred by Corporation pursuant to 43 U.S.C. xx 1606(j) (to the extent applicable); plus
- b. The Native shareholder's ratable portion of Corporation's basis, as determined by 43 U.S.C. § 1620(c), in the land and interests in land received by Corporation pursuant to ANCSA, minus the Native shareholder's ratable share of Corporation's basis in land and interest that ANCSA required (or requires) Corporation to transfer pursuant to 43 U.S.C. § 1613 and 43 U.S.C. § 1611 (to the extent applicable); minus
- c. Corporation's basis in land distributed to the Native shareholder pursuant to 43 U.S.C. § 1620(j); and

PLR-128894-00

- d. Any other adjustment to the shareholder's basis in stock required by the Code, including adjustments under § 301(c)(2).

14. For purposes of §§ 661 and 662, and except as provided in § 663(b), the reversion of Trust 2 Real Property from Trust 2 to Corporation is considered a distribution of trust property to Corporation in the year the reversion actually occurs. The Beneficiaries of Trust 2 will not be treated as receiving any distribution from Trust 2 on account of such reversion to Corporation.

15. Neither the establishment nor the funding of Trust 2 affects the ruling (PLR 9824002 (February 27, 1998)) issued to Corporation and Trust 1 except to the extent of any conditions stated in PLR 9824002. Furthermore, the potential termination and reversion of trust assets to Corporation will not affect PLR 9824002 except to the extent of any conditions stated in PLR 9824002.

We express no opinion about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects, resulting from, the transaction that are not specifically covered by the above rulings.

A copy of this letter should be attached to the federal tax return filed for Trust 2 for the taxable year ending in 2001. A copy is enclosed for that purpose.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that a private letter ruling may not be used or cited as precedent.

Sincerely yours,
J. THOMAS HINES
Chief, Branch 2
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

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Copy for section 6110 purposes