

Internal Revenue Service

Department of the Treasury

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Date:
October 18, 2001

Y =

X corp =

A =

B =

Dear :

This letter responds to your October 9, 2000, and subsequent correspondence, written on behalf of X corp, requesting rulings under § 664 for the formation and operation of a charitable remainder unitrust.

X corp is a subchapter S corporation within the meaning of § 1361 of the Code. A is X corp's sole shareholder and B is A's spouse.

X proposes to create Y, which is intended to qualify as a charitable remainder unitrust under § 664. X corp intends to contribute appreciated marketable securities to Y and Y will pay the unitrust amount in quarter annual installments to X corp for a period of 19 years, then to A and B equally for their lives, and then to the survivor of A and B for life. If X corp is liquidated before the end of the 19-year term, Y will pay the unitrust amount to the shareholder(s) of X corp for the remainder of the 19 years. The unitrust amount will be an amount equal to a specified percent (which is not less than 5 percent nor more than 50 percent) of the net fair market value of the assets of Y valued as of the first day of each taxable year of Y and will yield a present value passing to the charitable remainder beneficiary equal to at least 10% of the net fair market value of the property transferred to Y on the date of contribution. After the deaths of both A and B or at the end of the 19 years, whichever is later, the remainder of Y will be distributed to

qualified charitable organizations.

Section 664(d)(2) defines a charitable remainder unitrust as a trust that meets the requirements contained in § 664(d)(2)(A)-(D). In determining whether Y will qualify as a charitable remainder unitrust, we must first address whether the proposed trust will be properly classified as a trust for federal income tax purposes. This requires an analysis of the rules relating to identification of the grantor(s) of the proposed trust and the entity classification regulations.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of part I of Subchapter J, chapter 1, of the Code, which includes § 664, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) of property to a trust. However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under §§ 671 through 677 or 679.

Section 1.671-2(e)(2)(i) provides that a gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

Section 1.671-2(e)(2)(ii) provides that for the purposes of § 1.671-2(e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For purposes of this determination, an interest in the trust is not property received from the trust.

Section 1.671-2(e)(4) provides that, if a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust.

X corp proposes to create an arrangement in which a unitrust amount, based on a percentage of the fair market value of assets held by the proposed trust, is payable to X corp for 19 years and then to its shareholder and the shareholder's spouse for life. X corp's gratuitous transfer to Y is only partially for a business

purpose. A portion of the transfer will be for the benefit of its shareholder and his spouse. As a consequence, under § 1.671-2(e)(4), a portion of the appreciated marketable securities that X corp proposes to contribute to Y will be treated as constructively distributed to A, who then will be treated as making a gratuitous transfer of that property to Y. The amount of the constructive distribution will equal the present values of A's and B's unitrust interests and a proportional share of the charitable remainder interest. We conclude that, under the proposed arrangement, both A and X corp will be grantors of the proposed trust.

Section 301.7701-1(a)(1) of the Procedure and Administration Regulations provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or divide the profits therefrom.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 301.7701-4(a) provides that, in general, the term "trust" as used in the Code refers to an arrangement created either by a 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 court.

Section 301.7701-4(b) provides that there are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for the purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries.

Section 301.7701-4(c)(1) provides, in part, that an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders or if there are multiple classes of ownership interests where the existence of multiple classes of ownership

interests is not incidental to the purpose of facilitating direct investment in the assets of the trust. See also Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942).

Under the proposed arrangement, X corp and A will be treated as contributing assets to Y, the proposed trust. Throughout the term of the proposed trust, the trustee will have the power to vary the investment of the grantors by investing and reinvesting the assets in the trust, and as recipients of the unitrust amount, the grantors will share in the profits derived from the joint investment of their assets. X corp (or its shareholders if X corp liquidates) will receive the unitrust interest for a term of years, and A and B will receive the unitrust interest after the end of that term. Such an arrangement is not appropriately classified as a trust under either § 301.7701-4(a) or (c).

Because the proposed trust cannot be classified as a trust for federal income tax purposes, the proposed trust cannot meet the definition of a charitable remainder trust under § 664(d)(2). Because Y is not a charitable remainder trust, the remaining issues raised in X corp's ruling request are moot.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's representatives.

Sincerely yours,
JEANNE M. SULLIVAN
Acting Senior Technician Reviewer
Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes