

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR- 155800-01
Date:
April 10, 2002

Legend

A =

B =

C =

D =

X =

Trust =

Foundation =

Dear

This is in reply to your letter dated September 25, 2001 and subsequent correspondence, requesting various rulings under the Internal Revenue Code.

A and B, spouses, are grantors of Trust ("Grantors"). The beneficiaries of Trust are A, B, and, after their deaths, C ("Recipients"). A and D (an independent co-trustee) are co-trustees of Trust.

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Trust is intended to be a charitable remainder unitrust within the meaning of section 664(d)(2) of the Code. The deed of trust provides that each year the trustee will pay to Recipients during their lifetime the unitrust amount, which is equal to the lesser of (a) Trust income from the taxable year, as defined in section 643(b) of the Code, and (b) 6% of the net fair market value of the assets of Trust, valued as of the valuation date in each taxable year. Additionally, Trust contains a net income makeup provision, which provides that any excess income in any year to the extent the aggregate amounts paid in prior years was less than the aggregate amount, computed as 6% of the net fair market value of the trust assets on the valuation dates, shall be used to make up any deficit payment. Any income of Trust for a taxable year in excess of the unitrust amount is added to principal.

Upon the death of the survivor Recipient, the Trustee shall distribute all of the then principal and income of Trust to, or for the use of, Foundation. Foundation has been determined to be a private foundation, exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). Trust's document states that if Foundation is not an organization described in sections 170(c), 2055(a), and 2522(a) at the time when any principal or income of Trust is to be distributed to it, then the Trustee shall distribute such principal or income to such one or more organizations, consistent with the exempt purposes of Foundation, described in those sections.

A is also the president and sole shareholder of corporation X. X is, and always has been, a C corporation. X has one class of stock and 500 shares of stock outstanding. A and B propose to donate 495 shares to Trust, taking a charitable deduction for the donation for the present value of the charitable remainder after the proposed donation. A and B will continue to own the remaining five shares of stock. The X stock proposed to be donated to Trust has a tax basis of \$ 495 and an estimated current value \$594,000. The stock is closely held and has not historically paid dividends.

The value of X stock at the time of donation will be determined by an independent written appraisal by a qualified appraiser, conforming to all requirements for substantiation of contributions and for independent appraisals, including the filing of Form 8283 and if applicable, of Form 8282. The percentage of the independent appraised value that is deductible will be determined by the calculations under the appropriate regulations for donations to charitable remainder trusts, for the percentage of the appraised value of the stock that is contributed. Trust represents that no restrictions will be placed on the ownership of the stock by Trust, and Trust shall not be bound, or otherwise required to sell the stock.

X's board of directors may offer to redeem the stock owned by Trust. A represents that, if a redemption occurs, it will constitute a bona fide offer made on a uniform basis to all of the shareholders of X. A also represents that if a redemption is

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proposed and accepted, the redemption price will be the fair market value per share as determined by a qualified independent appraiser. In addition, A, as president and sole shareholder of X and grantor and co-trustee of Trust, represents the following:

- (1) I, A, grantor and co-trustee of Trust, hereby represent that neither I nor any family member of me will acquire, offer to acquire, or become obligated to acquire shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust.
- (2) I, A, President and sole shareholder of X, hereby represent that X will not redeem, offer to redeem, or become obligated to redeem shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust, directly or indirectly, by the grantor of Trust or a family member of the grantor.
- (3) I, A, President and sole shareholder of X, and grantor and co-trustee of Trust, hereby represent that neither X nor I am aware of any plan or intention of Trust to transfer any corporate stock, or to have any person acquire any corporate stock from Trust.

A requests the following rulings from the Service:

- (1) The income earned by X while part of its stock is owned by Trust will not constitute unrelated business taxable income to Trust;
- (2) Distributions to Trust from X while Trust owns part of its stock will constitute dividends that are excluded from unrelated business income under § 512(b)(1) of the Code, so long as they are not interest, annuities, royalties, and rents derived from the controlled corporation;
- (3) The redemption from Trust of its X stock, if X proposes and Trust accepts such a redemption, will not be an act of self-dealing as described in § 4941 of the Code and the regulations thereunder;
- (4) The sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

Ruling Requests 1 and 2

Section 664(c) of the Code provides that a charitable remainder unitrust shall, for any taxable year, not be subject to tax imposed by subtitle A, unless such trust, for such year, has unrelated business taxable income (within the meaning of section 512) (“UBTI”).

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Section 1.664-1(c) of the Income Tax Regulations provides that if a charitable remainder trust has any UBTI (within the meaning of section 512 and the regulations thereunder) for any taxable year, the trust is subject to all of the taxes imposed by subtitle A of the Code for such taxable year.

Section 511 of the Code imposes a tax on the UBTI of organizations exempt from federal income tax under section 501(a) of the Code.

Section 512(a)(1) of the Code defines the term “unrelated business taxable income” as gross income derived by an organization from an unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with such trade or business, both computed with the modifications provided in subsection (b).

Sections 512(b)(1), (2) and (3) of the Code provide that all dividends, interest, annuities, royalties and rents are excluded from the computation of UBTI.

Section 512(b)(13)(A) of the Code provides that notwithstanding section 512(b)(1), (2), and (3), an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity), shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

Section 512(b)(13)(C) of the Code provides that the term “specified payment” means any interest, annuity, royalty, or rent.

Section 512(b)(13)(D)(i) of the Code provides, in part, that the term “control” means in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of such corporation, and in any other case (other than a corporation or a partnership) ownership of more than 50 percent of the beneficial interests in the entity.

The modifications contained in section 512(b) of the Code, in effect, constitute an exception to the general rule by excluding from the computation of unrelated business taxable income items such as dividends, interest, annuities, royalties, and rents. If these modifications, which are provided in section 512(b)(1), (2), and (3), are considered an exception to the general rule of taxing the unrelated business income of exempt organizations, then section 512(b)(13) may be considered an exception to the exception. Under section 512(b)(13), the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) does not apply where such amounts are derived from “controlled organizations.”

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The exception to the modifications contained in section 512(b) of the Code is not applicable in this case. Although Trust, which holds the majority of X stock, is a “controlling organization” within the meaning of section 512(b)(13), the income earned by X while part of its stock is owned by Trust will not constitute UBTI to Trust. The distributions to Trust from X while Trust owns part of its stock are dividends. The receipt of dividends is not taxable to Trust, because section 512(b)(1) excludes dividends from the UBTI, and the rules of section 512(b)(13) do not apply to the payment of dividends.

Therefore, the income earned by X while part of its stock is owned by Trust will not constitute unrelated business taxable income to Trust. In addition, distributions to Trust from X while Trust owns part of its stock will constitute dividends that are excluded from unrelated business income under section 512(b)(1) of the Code, so long as they are not interest, annuities, royalties, and rents derived from the controlled corporation.

Ruling Request 3

Section 4941(a)(1) of the Code imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(a)(2) of the Code generally imposes a tax on the participation of a foundation manager in an act of self-dealing knowing that it is such an act, payable by the foundation manager.

Section 4941(d)(1)(E) of the Code provides that the term “self-dealing” includes any direct or indirect transfer to, or the use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4941(d)(2)(F) of the Code provides that an act of self-dealing will not be present in any transaction between a private foundation and a corporation which is a disqualified person where the parties enter into the transaction pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.

Section 4946(a)(1) of the Code provides, in pertinent part, that the term “disqualified person” means a person who is-

- (A) a substantial contributor to the foundation;
- (B) a foundation manager;

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(C) an owner of more than 20 percent of (i) the total combined voting power of a corporation . . . which is a substantial contributor to the foundation, . . .;

(D) a member of the family of any individual described in subparagraphs (A), (B), or (C);

(E) a corporation in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power.

Section 507(d)(2)(A) of the Code, which is applicable to unitrusts, provides that a substantial contributor includes a person who (1) contributes or bequeaths more than \$5,000 to a private foundation, and (2) the aggregate amount of the person's gifts and bequests amounts to more than two percent of the total contributions and bequests for all years received by the foundation before the close of the foundation's taxable year. This provision also provides that in the case of a trust, the creator of the trust is also a substantial contributor.

Section 4947(a)(2) of the Code provides generally that split-interest trusts are subject to the provisions of section 4941 in the same manner as if such trusts were private foundations, but, under section 4947(a)(2)(A), not with respect to any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under sections 170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B).

Section 53.4941(d)-2(a) of the foundation regulations provides that the sale of exchange of property between a private foundation and a disqualified person shall constitute an act of self-dealing.

Section 53.4941(d)-2(f)(1) of the foundation regulations provides that the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation shall constitute an act of self-dealing. For purposes of the preceding sentence, the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person.

Section 53.4941(d)-3(d)(1) of the foundation regulations provides that, in general, under section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person will not be an act of self-dealing if such transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, so long as all the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. For purposes of this paragraph, all of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation

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makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities.

Section 53.4946-1(f)(2) of the foundation regulations provides that the definition of a foundation manager includes a trustee, . . . of a foundation (or unitrust) or any person having powers or responsibilities similar to that of a trustee. . .

Section 53.4947-1(c)(2)(i) of the foundation regulations provides that under section 4947(a)(2)(A) of the Code, section 4941 does not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2)(B), 2522(e)(2)(B) with respect to the income interest of any such beneficiary.

As a charitable remainder unitrust under section 664(d)(2) of the Code, Trust is a split-interest trust described in section 4947(a)(2) and, therefore, subject to section 4941, which imposes an excise tax on acts of self-dealing. In order to have an act of self-dealing, there must be (1) a private foundation (or trust treated as a private foundation) and (2) a disqualified person.

After the contribution of X stock to Trust, Trust will hold 99 percent of the outstanding shares. Since persons described in section 4946(a)(1)(B)(C) or (D) of the Code will not own at least 35 percent of the combined voting power in X, X will not be a disqualified person with respect to Trust under section 4946(a)(1)(E). Therefore, a sale or exchange of property between X and Trust will generally not constitute self-dealing within the meaning of section 4941(d)(1)(A). Under section 4941(d)(1)(E), however, a self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. The term encompasses “any direct or indirect transfer to, or use by or for the benefit of, a disqualified person the income or assets of a private foundation.”

Section 53.4941(d)-2(f)(1) of the foundation regulations provides in part that “the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock to the advantage of a disqualified person.” However, a specific statutory exception to self-dealing is provided in section 4941(d)(2)(f) of the Code and section 53.4941(d)-3(d)(1) of the foundation regulations for transactions between a private foundation and a corporation which is a disqualified person pursuant to a redemption or other corporate reorganization.

Trust represents that, if a redemption occurs it will constitute a bona fide offer made on a uniform basis to all of the shareholders of X and will provide for receipt by Trust of no less than fair market value for any share Trust may elect to sell. Therefore, based on the information submitted and the representations Trust has made, if X redeems all or any portion of the stock held by Trust, the transaction would be

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described in section 53.4941(d)-3(d)(1) of the foundation regulations and excepted from self-dealing under section 4941(d)(2)(f) of the Code if X were a disqualified person with respect to the Trust. Since the transaction would not constitute self-dealing if X were a disqualified person with respect to Trust, it should also be excepted where, as here, Trust will own 99% of X stock and disqualified persons only 1%.

In reaching our conclusion with respect to the self-dealing issue described above, we are not approving any methodology to be used in determining the fair market value of X stock. We have merely accepted the taxpayer's representations that the redemption will be at fair market value.

In conclusion, the redemption from Trust of its X stock, if X proposes and Trust accepts such a redemption, will not be an act of self-dealing as described in section 4941 of the Code and the regulations thereunder, as long as the redemption is at fair market value.

Ruling Request 4

This request involves Palmer v. Commissioner, 62 T.C. 684 (1974), affd. on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq., 1978-1 C.B. 2. In the Palmer case, the Tax Court held that a taxpayer's gift of stock in a closely held corporation to a private foundation, followed by a redemption, was not to be recharacterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation, even though the taxpayer held voting control over both the corporation and the foundation. The Tax Court based its opinion, in part, on the fact that the foundation was not legally obligated to redeem the stock at the time it received title to the shares.

In Rev. Rul. 78-197, 1978-1 C.B. 83, the Internal Revenue Service announced that it will treat the proceeds of a redemption of stock under facts similar to those in the Palmer case as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.

In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.

Based on the representations submitted and information described above, we conclude that a purchase by X of the stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption

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of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

Except as specifically ruled upon above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provisions of the Code, including whether Trust qualifies as a charitable remainder unitrust under section 664(d)(2).

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

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to Trust's authorized representative.

Sincerely yours,

J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter

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