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TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

UIL: 512.10-00; 514.06-00; 4941.04-00

Date:
JAN 14 2003

Contact Person:

Identification Number:

Telephone Number:

T:EO:B3

Employer Identification Number:

LEGEND:

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Dear Sir or Madam:

This is in response to ruling requests involving issues under sections 512 and 4941 of the Code. Specifically, we are responding to your ruling requests concerning unrelated business taxable income as well as self-dealing.

The trustees of four charitable remainder unitrusts, M, N, O, and P, referred to hereafter as the "CRTs", propose to create and provide funds for a foreign corporation. With this funding, the foreign corporation will purchase interests in U.S. partnerships ("Funds").

The foreign corporation will be wholly owned by the CRTs collectively and will be treated as a corporation for U.S. income tax purposes. The foreign corporation will manage certain investments contributed to it by the CRTs and is expected to purchase, among other investments, an interest in one or more U.S. partnerships (Funds) which will manage a portfolio of securities and use debt financing to partially fund its acquisitions of those investment assets.

The debt-financed income will be distributed to the foreign corporation, which may, in turn, distribute it to the CRTs. The foreign corporation will purchase investment assets with contributed cash from the CRTs, or from borrowing.

Each of M, N, O, and P was created by A and B under different trust instruments. They are the donors/substantial contributors to each CRT. The income beneficiary of each CRT is A and B. The trustee of each of the CRTs is a commercial bank and one of the children of A or A and B. The unitrust amount payable to the income beneficiaries varies from trust to trust in a range of 5 percent to 11 percent. Each CRT provides that on the death of both donors, the remainder will be distributed to R, a private foundation created by A and B. Each CRT was originally funded with shares of stock of X corporation, a publicly traded company.

R is a corporation organized under the law of state t, and was created by A and B, who are the substantial contributors. R received exemption from tax under section 501(c)(3) from the Service, and was classified as a private foundation by a letter issued in a.

The foreign corporation will be governed by the laws of foreign country v. It will be treated as a corporation for U.S. income tax purposes. All corporate formalities with respect to the foreign corporation will be followed, the status of the foreign corporation and its assets as separate from the CRTs and their assets will be observed, and the foreign corporation will not act as the agent for any of the CRTs or the CRTs' trustees. None of the entities will incur debt in order to create and fund the foreign corporation.

It is anticipated that the Funds will acquire and actively manage a diverse portfolio of securities. It is also anticipated that the Funds will use debt financing to partially fund its acquisition of assets. Such debt financing would result in income that is considered unrelated business taxable income for purposes of section 511 and section 664(c) of the Code if it were incurred directly by the CRTs. The debt-financed income will be distributed to the foreign corporation and the foreign corporation may either reinvest the amount or distribute some portion to the CRTs as a dividend.

The trustees of the CRTs represent that they have a number of business purposes for establishing the foreign corporation and pooling the assets of the CRTs. Such reasons include the fact the foreign corporation may manage and administer the CRTs' investments as a group. This will help minimize the administrative and advisor costs of investing, help diversify assets, and gain access to additional investment opportunities. Further, the use of the foreign corporation will provide an additional layer of limited liability protection for the CRTs against liabilities in the evolving area of lender liability and against other liabilities. The foreign corporation provides greater flexibility for investment in that stock of the corporation may be more readily transferred than other investment forms.

By a letter dated April 8, 2002, the CRTs provided additional information. It is expected that each CRT will contribute to the foreign corporation an amount equal to ten to twenty percent of each CRTs' total value. The total value of all contributions is approximately z. The CRTs expect to contribute only cash to the foreign corporation.

The letter of April 8, 2002, further provides that there will be no special voting rights in the foreign corporation. The voting rights will be strictly proportional to the equity interest held by each CRT. The equity interest of each CRT in the foreign corporation after the asset transfers by the CRTs varies from trust to trust.

M, N, O, and P have requested the following rulings of our office:

1. The foreign corporation's distributive share of a Fund's income and gains under section 704 will not constitute unrelated business taxable income to any of the CRTs.
2. The amounts distributed by a Fund to the foreign corporation will not constitute unrelated business taxable income to any of the CRTs.
3. The amounts distributed by the foreign corporation to the CRTs will not constitute unrelated business taxable income to any of the CRTs.
4. The amounts of subpart F income derived by the CRTs from their ownership of the foreign corporation will not constitute unrelated business taxable income to any of the CRTs.
5. The formation and operation of the foreign corporation as set forth above will not constitute an act of self-dealing under section 4941.

LAW AND ANALYSIS:

Ruling Requests 1, 2, 3, and 4:

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

Section 512(a)(1) of the Code defines UBTI as the gross income derived from an unrelated trade or business regularly carried on, less allowable deductions, and subject to certain modifications.

Section 512(b)(1) of the Code provides that dividends received or accrued shall be excluded from UBTI.

Section 512(b)(4) of the Code provides that notwithstanding the general exclusion of dividends from UBTI, dividends and other passive investment income derived from certain debt-financed property (and corresponding deductions) are included, as an item of gross income derived from an unrelated trade or business, in an amount ascertained under section 514 of the Code.

Section 512(b)(13) of the Code, as amended by the Taxpayer Relief Act of 1997, provides that certain items of income received from a controlled entity will be considered to be derived from an unrelated trade or business. Dividends are not included among the items of income covered by section 512(b)(13) of the Code.

Section 512(b)(17) of the Code, added by the Small Business Job Protection Act of 1996, provides that any amount included in gross income under section 951(a)(1)(A) shall be included as an item of gross income derived from an unrelated trade or business to the extent that the amount so included is attributable to insurance income as defined in section 953 of the Code.

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code defines unrelated trade or business as any trade or business, the conduct of which is not substantially related to the performance of exempt purposes or functions.

Section 514 of the Code provides that the term "unrelated business income" includes "unrelated debt-financed income" from investment property. The investment income included is proportionate to the debt on the property.

Section 514(b) of the Code provides that the term "debt-financed property" means any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

Section 664(c) of the Code provides that a trust is exempt from income taxes for any taxable year unless the trust has UBTI for such year. If the trust has UBTI for any taxable year, then the trust is not exempt from taxes, and is subject to taxation under the normal rules of Subchapter J of the Code.

The House Ways and Means Committee Report on the Small Business Job Protection Act of 1996, in describing section 512(b)(17), states that "income inclusions under Subpart F have been characterized as dividends for unrelated business income tax purposes."

Sections 951 through 964 comprise Subpart F – Controlled Foreign Corporations. Section 951(a)(1)(A) provides that a United States shareholder of a controlled foreign corporation must include in gross income his pro rata share of the controlled foreign corporation's Subpart F income for the year, even if not distributed. Section 954(c)(1) of the Code provides that Subpart F income includes investment income.

Prior to the enactment of section 512(b)(17) of the Code in 1996, it was unclear whether exempt organizations that conducted insurance activities through a foreign corporation were subject to U.S. tax with respect such activities. The Internal Revenue Service issued a series of private letter rulings stating that amounts distributed by the controlled foreign corporation (and thus includible in its shareholders' income under subpart F) were characterized as dividends for

unrelated business income tax purposes and thus were not taxed. But a private letter ruling to the contrary was also issued. (PLR 9043039).

Section 512(b)(17) of the Code was enacted to provide that where a controlled foreign corporation is insuring third-party risks (providing insurance to entities other than the exempt organization which controls the controlled foreign corporation and certain related parties), the income from that activity will be taxable as unrelated business income. The House Ways and Means Committee Report on the new provision discusses favorably the rulings issued by the Service which characterized Subpart F inclusions as dividends and thus not taxable as unrelated business income. The Committee Report also refers unfavorably to ruling 9043039 which used a look through rule to characterize subpart F income.

In the case at hand, the income derived by the foreign corporation from the Fund will not originate from insurance activities as defined in section 953 of the Code. It appears clear that Congress intended such noninsurance income to be treated as dividend income when paid or deemed distributed to shareholders of controlled foreign corporations.

Under sections 512(c), 512(b)(4), and 514, income from the Fund would be UBIT to the CRTs if received directly by them because it is debt-financed income. However, here the income will be distributed to the CRTs indirectly through the foreign corporation, which will pay dividends to the CRTs. Dividend income is not taxable under section 512(b)(1) of the Code. Further, the CRTs have not themselves incurred debt in financing their interest in the foreign corporation, and thus such dividend income is not debt-financed income described in section 514 of the Code.

Based on the information submitted, we rule as follows:

1. The foreign corporation's distributive share of the Funds' income and gains under section 704 will not constitute unrelated business taxable income to any of the CRTs, M, N, O, or P.

2. The amounts distributed by the Fund to the foreign corporation will not constitute unrelated business taxable income to any of the CRTs, M, N, O, or P.

3. The amounts distributed by the foreign corporation will not constitute unrelated business taxable income to any of the CRTs, M, N, O, or P.

4. The amounts of Subpart F income derived by the CRTs from their ownership of the foreign corporation will not constitute unrelated business taxable income to any of the CRTs, M, N, O, or P.

Ruling Request 5:

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

Section 4941(d)(1)(A) of the Code defines the term self-dealing to include a sale or exchange of property between a private foundation and a disqualified person.

Section 4941(d)(1)(E) of the Code defines the term self-dealing to include a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946(a)(1)(A) and 507(d)(2) of the Code defines the term "disqualified person" to include a substantial contributor to the foundation.

Section 4946(a)(1)(G) of the Code defines the term "disqualified person" to include a trust or estate in which persons described in paragraph (A), (B), (C), or (D) own more than 35 percent of the beneficial interest.

Section 4947(a)(2) of the Code provides, in essence, that a split interest trust meeting certain requirements, including a charitable remainder trust, is subject to the prohibitions of section 4941 of the Code, other provisions of chapter 42 of the Code, and other specified sections of the Code.

Section 53.4941(d)-1 of the Regulations provides, in part, that the term "self-dealing" does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of such transaction.

Section 53.4941(d)-2(f)(2) provides, in part, that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

The CRTs own the stock of foreign corporation. A and B, as substantial contributors to each CRT, are disqualified persons to the CRTs. Since the value of their income interest with respect to the CRT payment is likely to exceed 35 percent, each CRT is a disqualified person to one another. A and B are deemed to own the stock of the foreign corporation by virtue of the ownership of the foreign corporation by the CRTs. Section 267(c) and the regulations thereunder. Thus, the foreign corporation is a disqualified person at the conclusion of the equity ownership transfers to the CRTs.

In this case, O and the related CRTs are investing only cash in the corporation. There is no non-section 664 disqualified person involved in this transaction and related private foundation R will not be a participating investor. The investments by the CRTs are not benefiting any disqualified persons other than themselves. The transaction is comparable to one in which O would be the only charitable remainder trust investor. Accordingly, the four CRTs' investment activity in the foreign corporation does not constitute an act of self-dealing.

Accordingly, we rule as follows:

5. The formation and operation of the foreign corporation as set forth in this request will not constitute an act of self-dealing under section 4941 of the Code with respect to M, N, O, or P.

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

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

This ruling is directed only to the person that requested it. Internal Revenue Code section 6110(k)(3) provides that it may not be used or cited as precedent. This ruling does not purport to rule on any other issue or Code section not addressed herein.

Sincerely,

(signed) Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3