

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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676.00-00; 461.07-02
CASE MIS No.: TAM-106657-99/CC:DOM:IT&A:B5

Date: February 3, 2000

District Director:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

Partnership =

Plaintiff =

ISSUES:

- (1) Should Taxpayer be treated as a grantor trust instead of a complex trust?
- (2) If Taxpayer is properly treated as a grantor trust, are there any legal or equitable doctrines that provide a basis for partial or total disallowance of the claims for refund?

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CONCLUSIONS:

(1) Taxpayer should not be treated as a grantor trust;

(2) Because Taxpayer is not properly treated as a grantor trust, it is not necessary to determine whether there are legal doctrines that provide a basis for a total disallowance of the claims for a refund.

FACTS:

The information submitted indicates that in _____, Plaintiff filed a suit against Partnership for negligence and other claims related to _____ with respect to a corporation that a subsidiary of Plaintiff had purchased. In _____, there was a jury verdict against Partnership in the amount of _____. In _____, Taxpayer was established and Partnership transferred _____ in cash to Taxpayer. In _____, the trial court granted Partnership's motion for a new trial. In _____, an appellate court issued its opinion and remanded the case for a new trial. A new trial has not yet started.

Partnership (a cash basis taxpayer) deducted on its 1992 Form 1065 return the funding of Taxpayer under sections 162 and 461(f) of the Internal Revenue Code. With respect to the taxable years 1992 through 1995, Taxpayer filed returns as a complex trust and reported income and paid tax for each of those years. During those same years, Partnership funded the taxes paid by Taxpayer and deducted those amounts. With respect to the 1996 and 1997 taxable years, Taxpayer filed returns stating that it was a wholly-owned grantor trust. During those years, Partnership reported the income of Taxpayer and also deducted those amounts as constructive contributions to Taxpayer. In April of 1997, Taxpayer filed amended returns for 1993 through 1995 claiming that it should always have been treated as a grantor trust instead of a complex trust and, therefore, is entitled to refunds of taxes that were paid with respect to those years. Partnership claims that it mistakenly filed as a complex trust for 1993 through 1995. The statute of limitations for Partnership's _____ taxable year has expired.

The Trust Agreement provides that:

1. Partnership and certain of its partners desire to create a trust for the benefit of Plaintiff to hold assets that would be used to satisfy all or part of the liability, if any, that Partnership is finally determined to have with respect to the claims asserted against it by Plaintiff in the lawsuit.
2. That Plaintiff shall have no duty to execute or give credit to or marshal assets of Taxpayer's estate prior to executing on other assets of _____

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Partnership.

3. Section 3 of the trust agreement provides that upon the occurrence of a final determination, the trustee shall liquidate the non-cash assets of Taxpayer and make such payment to the Plaintiff out of the Taxpayer's estate as is necessary to discharge to the maximum extent possible the liability, if any, that Partnership is determined to have to Plaintiff with respect to the claims pursuant to such final determination, net of any applicable insurance coverage that Partnership may have with respect to any such liability (it being understood that Taxpayer's estate may not be sufficient to fully discharge any such liability and that the trust agreement shall not limit any recourse that Plaintiff may have against other assets of Partnership). The remaining portion of Taxpayer's estate, if any, shall then be distributed to the partners of Partnership on whose behalf Taxpayer was funded (and the trustee may either (i) rely conclusively upon a certificate of Partnership regarding the identity of, and the amounts to be distributed to, each such partner or (ii) pay to Partnership, in trust, any amounts to be distributed to such partners, for distribution by Partnership to such partners on behalf of Taxpayer).

LAW AND ANALYSIS:

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying out any trade or business.

Section 461(a) provides that the amount of any deduction or credit allowed by subtitle A shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(f) provides that if (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of section 461(h), then the deduction shall be allowed for the taxable year of the transfer.

Section 1.461-2(c)(1) of the Income Tax Regulations provides that a taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond the taxpayer's control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to

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an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest.

Section 1.461-2(f) regarding the treatment of money or other property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto is reserved.

Section 641 provides that the tax imposed by section 1(e) shall apply to the taxable income of any kind of property held in trust.

Section 671 provides that where it is specified in subpart E that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Sections 673 through 677 specify the circumstances that cause a taxpayer to be regarded as the owner of a portion of a trust.

Section 677(a) of the Code provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor; or (2) held or accumulated for future distribution to the grantor.

Section 1.677(a)-1(d) provides that under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.

The rules of section 461(f) and section 1.461-2(c) preclude Taxpayer from being treated as owned by Partnership under subpart E. If Partnership is entitled to a deduction for amounts contributed to Taxpayer under section 461(f), it is fundamentally inconsistent for Partnership to also be treated as the owner of all the assets of Taxpayer for federal income tax purposes. For example, if Partnership were treated as the owner of Taxpayer, when amounts that were contributed by Partnership to Taxpayer are paid from Taxpayer for deductible expenses, further deductions might be claimed by Partnership for amounts already deducted upon transfer to Taxpayer. Therefore, the provisions of subpart E cannot apply to treat Partnership as the owner of any portion of Taxpayer for which deductions are allowed under section 461(f) and section 1.461-2(c). Instead the tax imposed by section 1(e) will apply to the taxable

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income of Taxpayer pursuant to section 641 and subparts A, B, C and D, part I, subchapter J, chapter 1 of the Code will apply to Taxpayer.

Because Taxpayer is not a grantor trust for federal tax purposes, it is not entitled to the requested refunds and there is no need to address the second issue.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

By: Richard L. Carlisle, Acting Chief, Branch 5