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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-134446-02
Date:
April 4, 2003

Legend

X =

Trust =

Date 1 =

Date 2 =

n =

Group =

p =

\$a =

\$b =

Stock A =

Stock B =

Dear

This responds to your letter dated May 16, 2002, submitted on behalf of X and Trust, requesting rulings on several issues arising from the establishment, funding and potential termination of Trust under § 646 of the Internal Revenue Code and other provisions.

In 1971, the Alaska Native Claims Settlement Act of 1971 (ANCSA), 43 U.S.C. 1601 *et seq.*, settled the Alaska natives' claims to land and resources. ANCSA implements the settlement of Native Alaskans' aboriginal land claims by providing for the conveyance of certain lands and money (Alaska Native Fund, or ANF) to Alaska Native Corporations (ANC) established by qualified Alaska natives as compensation. 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 natives who qualified to participate in the settlement were allowed to enroll as stockholders and receive stock (Settlement Common Stock) in one of the twelve regional corporations and in one local village corporation created under the Act to receive assets.

The ANCSA, as originally enacted, provided that for a period of 20 years after December 18, 1971, the stock, inchoate rights thereto, and any dividends paid or distributions made with respect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, did 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 provided 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 ANC unless and until the shareholders of the corporation decide to terminate them. 43 U.S.C. § 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 U.S.C. § 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 Amendment of 1987 authorizes the conveyance of certain assets of an ANC to a state-chartered Settlement Trust. 43 U.S.C. § 1629e. The general purpose of a 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 U.S.C. § 1629e.

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 U.S.C. §§ 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 U.S.C. § 1629e(a)(1)(B).

Section 646 was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Section 646 addresses several aspects concerning the tax treatment of Alaska Native Settlement Trusts.

The information submitted states that X was incorporated in Date 1 as an ANC pursuant to the ANCSA and Alaska state law. X has approximately n shareholders, predominantly of native Alaskan Group descent. On Date 2, X's Board of Directors approved a plan to begin the process of establishing the Trust.

The objective of the Trust is to provide distributions to X's elder shareholders who are the Trust's beneficiaries, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives. X will fund the Trust with approximately \$a of cash and assets. The Trust may not be altered, amended or terminated except as provided in the Trust document. The Trust provides for termination if the Trust distributes all of its net assets, an event occurs that has a materially adverse effect on the Trust's objectives, X terminates or there are no remaining beneficiaries.

The beneficiaries of the Trust will be living individuals who are 65 years old or older, received Stock A or Stock B from X as part of the original issuance of shares in connection with the formation of X and own at least one share of X's Settlement Common Stock. The Trust will distribute \$b quarterly to each person who meets the above definition of beneficiary. If there is not sufficient net assets to make a \$b quarterly payment to each beneficiary, the Trust shall make as large a distribution as possible. A beneficiary may disclaim any right to a future distribution or set of future distributions from the Trust. Such disclaimer will extinguish all legal rights of that beneficiary to the distribution(s) disclaimed. Additionally, a beneficiary may not sell, assign, hypothecate or transfer any interest in the Trust.

The Trust provides that there will be p trustees, all of whom will be natural persons, as required by ANCSA, and at least one of whom will be an Alaska resident. At all times, a majority plus one of the p trustees may not be employees of X or X's affiliates. X's Board of Directors will appoint the trustees and have the power to remove any trustee for cause. In the event X is merged, dissolved, or consolidated, or X's shareholders vote to terminate the alienation restrictions on the X Settlement Common Stock, but the Trust did not terminate, the Trustees will appoint their own successors. If federal or local law does not permit the Trustees to appoint their successors, X's Board of Directors will continue to appoint the Trustees, unless X no longer exists. If X no longer exists, but there is a successor ANC corporation, the successor ANC will appoint

the Trustees. If there is no such successor ANC, the Trustees will hold office indefinitely. The Trust authorizes the Trustees to act as owners of the Trust. However, the Trustees are prohibited from exercising any power primarily for the benefit of X or its affiliates rather than for the benefit of the beneficiaries.

Section 301.7701-4(a) of the Procedure and Administration Regulations provides that, in general, an arrangement will be treated as a trust under the 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, the Trust is properly classified as a trust described in § 301.7701-4(a).

Section 646(a) provides that if a § 646 election is in effect with respect to any Settlement Trust, the provisions of § 646 shall apply in determining the income tax treatment of the Settlement Trust and its beneficiaries with respect to the Settlement Trust. Provided that the Trust meets all the requirements to be a Settlement Trust, including making the necessary election under § 646(c), we conclude that § 646 governs the income tax treatment of the Trust. Accordingly, subpart E of part I of subchapter J of chapter 1 of the Code (grantor trust provisions) will not govern the income tax treatment of the Trust during any period that the § 646 election is in effect for the Trust.

Additionally, X requests a ruling that the Trust is not a grantor trust under subpart E for any period during which the § 646 election is not in effect for the Trust. Section 646 will sunset on December 31, 2010; thus, it is necessary to determine whether the Trust would be a grantor trust under subpart E after the sunset of § 646. The following analysis and conclusions are based on current provisions of the Code, which provisions may or may not be applicable after the sunset of § 646.

Section 671 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.

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. Our examination of the Trust reveals none of the circumstances that would cause the grantor or any other person to be treated as the owner of any portion of the Trust 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 reveals none of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of the grantor under § 675 of the Code. Thus, the circumstances attendant on the operation of the Trust will determine whether the grantor will be treated as the owner of any portion of the Trust under § 675. This is a question of fact, the determination of which must be made by the Director, Field Operations 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 the grantor 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.

Section 1.677(a)-1(d) of the Income Tax Regulations provides that a grantor shall be 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.

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 Settlement Trust, or their conveyance rendered the corporation insolvent or occurred when the corporation was insolvent. 43 U.S.C. § 1629e(c)(5). The Trust provides that for those liabilities of X existing at the time X transfers assets to the Trust, creditors can reach the Trust assets only if the assets remaining in X are inadequate to satisfy such liabilities. Furthermore, the Trust assets may not be used to satisfy any other liability of X. X represents that retained corporate assets after the transfer of assets to the Trust will be more than adequate to meet X's obligations.

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

Section 301(a) provides, in general, that except as otherwise provided, 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.

Section 301(d) provides that the basis of property received in a distribution to which § 301(a) applies shall be the fair market value of such property.

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

Section 646(d)(1) provides that in the case of an electing Settlement Trust, no amount shall be includible in the gross income of a beneficiary of such trust by reason of a contribution to such trust.

Section 646(d)(2) provides that the earnings and profits of the sponsoring Native Corporation shall not be reduced on account of any contribution to such Settlement Trust.

Section 646(g) provides that the taxable income of an electing Settlement Trust shall be determined under § 641(b) without regard to any deduction under § 651 or § 661.

Section 1015(b) provides that if property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

Section 1223(2) provides that, in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which the property was held by any other person, if under chapter 1 of the Code such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Provided that the Trust meets all the requirements to be a Settlement Trust, including making the necessary election under § 646(c), we conclude that no amount shall be included in the gross income of X's shareholders or Trust beneficiaries when X contributes property (including cash) to the Trust. Section 646(d)(1).

X's contributions to the Trust do not constitute gross income to the Trust.

X must recognize gain on any property (including ANCSA land) contributed to the Trust that has a fair market value in excess of its basis, in an amount equal to the excess of its fair market value over its adjusted basis. Section 311(b). The basis of such property in the hands of the Trust shall be equal to its fair market value on the day it is contributed to the Trust. Section 301(d). The Trust's holding period for this property begins on the day the Trust receives the property. Cf. section 1223(2).

Property that is contributed to the Trust that is not subject to § 311(b), as provided above, must be treated as property transferred to the Trust subject to §1015(b), so that X's basis in such property carries over to the Trust. Section §1015(b). Additionally, the Trust's holding period shall include the period for which X held those assets. Section 1223(2).

Section 646(i) provides that any loss that would otherwise be recognized by a shareholder upon a disposition of a share of stock of a sponsoring Native Corporation shall be reduced (but not below zero) by the per share loss adjustment factor. The per share loss adjustment factor shall be the aggregate of all contributions to all electing Settlement Trusts sponsored by such Native Corporation made on or after the first day each trust is treated as an electing Settlement Trust expressed on a per share basis and determined as of the day of each such contribution.

Since any loss allowed on the disposition of ANC stock must be reduced by the aggregate of all contributions, expressed on a per share basis, a reduction of basis in X stock at the time X makes contributions to the Trust is not appropriate. Therefore, an X shareholder's basis in X stock will not be reduced by reason of contributions made to the Trust. Section 646(i).

Section 901(a) of EGTRRA provides a "sunset" provision that all provisions of, and amendments made by, EGTRRA shall not apply (1) to taxable, plan, or limitation years beginning after December 31, 2010, or (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010. The legislative history states that for such taxable years beginning after December 31, 2010, the tax consequences of any election previously made under § 646, and any right to make a future election, shall be terminated. Furthermore, any electing Trust then in existence, its beneficiaries, and the sponsoring ANC shall be taxed under the provisions of law in effect immediately prior to the enactment of § 646. H.R. Conf. Rep. No. 107-84, at 305 (2001). Therefore, we conclude that the sunset of § 646 will not be treated as causing a taxable distribution from X to the Trust or its beneficiaries, or to X's shareholders, with respect to any contributions made by X to the Trust during any years for which the Trust has a § 646 election in effect.

Section 646(b)(1) provides that there is imposed on the taxable income of an electing Settlement Trust, other than its net capital gain, a tax at the lowest rate specified in § 1(c).

Section 646(b)(2) provides that in the case of an electing Settlement Trust with a net capital gain for the taxable year, a tax is imposed on such gain at the rate of tax that would apply to such gain if the taxpayer were subject to a tax on its other taxable income at only the lowest rate specified in § 1(c).

Section 1(c) provides that there is imposed on the taxable income of every individual who is not a married individual, a tax of 15% of taxable income if the taxable income is not over \$22,100.

Section 1(i)(1)(A) provides that in the case of taxable years beginning after

December 31, 2000, (i) the rate of tax under § 1(c) on taxable income not over the initial bracket amount shall be 10% and (ii) the 15% rate of tax shall apply only to taxable income over the initial bracket amount (as defined in § 1(i)(1)(B)(iii)) but not over the maximum dollar amount of the 15% rate bracket.

Section 1(h) provides rules concerning the maximum capital gains rate.

The legislative history of § 646 states that “[a]n electing Trust will pay tax on its income at the lowest rate specified for ordinary income of an individual (or corresponding lower capital gains rate).” H.R. Conf. Rep. No. 107-84, at 301 (2001). Accordingly, we interpret the provisions of § 646(b) to provide that the aggregate tax imposed by that subsection on the taxable income of an electing Settlement Trust (including its net capital gain) is no greater than an amount equal to the lowest rate specified in § 1(c), taking into account all relevant provisions of the Code (including § 1(i)), applied to such taxable income. Moreover, when there is a net capital gain, the effect of the provisions of § 1(h) could result in a lesser tax on the net capital gain, such as where there is qualified 5-year gain.

Provided that an election under § 646(c) is properly made with respect to the Trust, and such election has not ceased to apply, we conclude that the tax rate imposed upon the Trust, other than net capital gains, will be the lowest rate under § 1(c), taking into account all relevant provisions of the Code, including § 1(i). Additionally, we conclude that the tax imposed on the net capital gain of the Trust (taking into account the provisions of § 1(h)) is at the rate of tax that would apply to such gain if the Trust were subject to a tax on its other taxable income at only the lowest rate specified in § 1(c), taking into account all relevant provisions of the Code (including § 1(i)).

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. The Trust 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. Section 301.7701-4(a).
2. The income tax treatment of the Trust shall be governed by § 646 for any years for which the Trust has a § 646 election in effect. Section 646(a).
3. Neither X nor any other person shall be treated for federal income tax purposes as the owner of the Trust or any portion of the Trust under current §§ 673 - 678 for any years for which the Trust does not have a § 646 election in effect (e.g., after the sunset of § 646).
4. No amount shall be included in the gross income of X's shareholders or Trust beneficiaries when X contributes property (including cash) to the

Trust. Section 646(d)(1).

5. X's contributions to the Trust do not constitute gross income to the Trust.

6. X must recognize gain on any property (including ANCSA land) contributed to the Trust that has a fair market value in excess of its basis, in an amount equal to the excess of its fair market value over its adjusted basis. Section 311(b). The basis of such property in the hands of the Trust shall be equal to its fair market value on the day it is contributed to the Trust. Section 301(d). The Trust's holding period for this property begins on the day the Trust receives the property. Cf. section 1223(2).

7. Except as provided in Ruling 6, property transferred to the Trust must be treated as property transferred to the Trust subject to § 1015(b), so that X's basis in such property carries over to the Trust. Section 1015(b). Additionally, the Trust's holding period shall include the period for which X held those assets. Section 1223(2).

8. An X shareholder's basis in X stock shall not be reduced by reason of contributions made to the Trust. Section 646(i).

9. The sunset of § 646 will not be treated as causing a taxable distribution from X to the Trust or its beneficiaries, or to X's shareholders with respect to any contributions made by X to the Trust during any years for which the Trust has a valid § 646 election in effect.

10. The tax rate imposed upon the Trust, other than net capital gains, will be the lowest rate under § 1(c), taking into account all relevant provisions of the Code (including § 1(i)).

11. The tax imposed on the net capital gain of the Trust (taking into account the provisions of § 1(h)) is at the rate of tax that would apply to such gain if the Trust were subject to a tax on its other taxable income at only the lowest rate specified in § 1(c), taking into account all relevant provisions of the Code (including § 1(i)).

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any other provision of the Code. Additionally, with the exception of Rulings 1, 3 and 9, the above rulings are conditioned upon an election under § 646(c) having been properly made with respect to the Trust and such election remaining in effect and having not ceased to apply.

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

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X and X's second representative.

Sincerely,

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

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes