**Internal Revenue Service**

Number: **200335029**
Release Date: 8/29/2003
Index Number: 671.00-00, 1222.00-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:PSI:2 - PLR-162170-02
Date:
May 30, 2003

X =

Year 1 =

Year 2 =

D1 =

D2 =

Month =

a =

b =

Company =

New Company =

Trust =

Dear :

This letter responds to a letter dated November 8, 2002, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting certain rulings under the Internal Revenue Code.

The information submitted states that X is a non-profit corporation, which is represented as being a tax-exempt organization described in § 501(c)(3) of the Code. X and its affiliates maintain three plans providing employee benefits including life and disability insurance (the Plans). The Plans are funded entirely by employee contributions made on an after-tax basis. The benefits under these plans are insured by Company, with X as the named policyholder of all three group insurance policies. X's employees are the beneficiaries of the Plans.

In Year 1, Company announced its intent to convert from a mutual insurance company to a stock insurance company as part of a corporate reorganization to a publicly-traded New Company. The reorganization has been determined to constitute a tax-free reorganization described in § 368(a)(1)(E). Under state law, Company was required to pay consideration, known as "demutualization proceeds," to its mutual policyholders in exchange for their proprietary rights in the mutual company. The demutualization proceeds could be paid in the form of stock, cash, or "policy credits." Company determined that X, as a policyholder on D1 of Year 1, the date on which the reorganization plan was adopted, would receive the demutualization proceeds in the form of New Company stock. The amount of the demutualization proceeds was based on the policyholder's "actuarial contribution" to Company's surplus attributable to the policies held by the policyholder, defined as the accumulated contribution that the policies were estimated to have made in the past to Company's surplus, plus the estimated present value of the contribution that the policies would make in the future. Company determined that the demutualization proceeds for the three policies held by X were approximately $a. The policies remained in effect, with X as policyholder, and the employee beneficiaries continuing to pay all premiums on an after-tax basis. It has previously been determined that no gain or loss was recognized by policyholders who received New Company stock under the reorganization pursuant to § 354(a)(1), that the policyholders had a zero basis in the New Company stock received pursuant to § 358(a)(1), and that a policyholder's holding period in the New Company stock includes the period during which the policyholder held the insurance policy, provided that the stock is a capital asset in the hands of the policyholder.

On D2, X formed Trust to receive the demutualization proceeds, which were determined to be "plan assets" under the Employee Retirement Security Act, 29 U.S.C. §§ 1001 et seq. X represents that the Trust is not a trust described in § 1.671-4(b)(6) or (7). X assigned its rights as policyholder to the receipt of the demutualization proceeds to the Trust. In Year 2, the demutualization proceeds, in the form of New Company stock, were issued to the Trust. In Month of Year 2, the trustee of the Trust sold the New Company stock pursuant to a direction from X, and invested the sale proceeds in short-term money-market instruments.

X determined that it would direct the trustee of the Trust to distribute the sale proceeds (in cash form) to the employees who were active participants in the Plans as of the end of Year 1, a total of about b beneficiaries. An individual beneficiary's share of the proceeds is determined on the basis of a formula taking into account the amount of premiums and any additional payments made under the policies by that beneficiary.

Since the sale of the New Company stock in Month of Year 2, the sale proceeds have earned interest. Legal expenses have also been incurred with regard to the formation of the Trust.

Section 9.1 of the Trust provides that X shall have the right to amend the Trust, except that it may not amend the Trust to use any part of the corpus or income of the

Trust for any purpose other than the exclusive benefit of the participants in the Plans and the payment of expenses otherwise provided for in the Trust or the Plans.

Section 9.2 of the Trust provides that X may terminate the Trust at any time. In the event of the termination, the Trust assets shall be distributed in accordance with the Plans, but in no event shall any part of the Trust assets attributable to the Plans revert to X.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J 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 which 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.

Section 672 (a) defines "adverse party," for purposes of subpart E, as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

Section 672(b) defines "nonadverse party", for purposes of subpart E, as any person who is not an adverse party.

Section 676(a) 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 any other provision of part I, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Section 677(a)(1) provides, in general, 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 § 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 distributed to the grantor or the grantor's spouse.

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions. None of the exceptions is relevant in this case. Section 1231 applies to property of a character which is subject to the allowance for depreciation provided in § 167 or real property used in a trade or business that does not fall within certain exceptions generally equivalent to the exceptions in § 1221.

Section 1222(3) provides that for purposes of subtitle A, the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

Section 1223(1) provides, for purposes of subtitle A, that in determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under chapter 1, the 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 the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in § 1221 or property described in § 1231.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of part I of subchapter J, chapter 1, 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. For purposes of § 1.671-2(e)(1), the term *property* includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the 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 1.671-4(a) provides that except as otherwise provided in § 1.671-4(b), items of income, deduction, and credit attributable to any portion of a trust which under the provisions of subpart E is treated as owned by the grantor or another person are not reported by the trust on Form 1041, U.S. Income Tax Return for Estates and Trusts, but are shown on a separate statement to be attached to that form.

Section 1.671-4(b)(1) provides, in general, that in the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in § 1.671-4(b)(6) and (7), the trustee may, but is not required to, report by one of the methods described in § 1.671-4(b) rather than § 1.671-4(a).

Section 1.671-4(b)(3) provides, in general, that in the case of a trust all of which is treated as owned by two or more grantors or other persons, the trustee must furnish the name, taxpayer identification number (TIN), and address of the trust to all payors for the taxable year. Additionally, the trustee must file with the Service the appropriate Forms 1099, U.S. Information Return, reporting the items of income paid to the trust by all payors during the taxable year attributable to the portion of the trust treated as owned by each grantor or other person treated as an owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. The trustee must also furnish to each grantor or other person treated as an owner of the trust a statement that (i) shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor or other person; (ii) provides the grantor or other person treated as an owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and (iii) informs the grantor or other person treated as the owner of the trust that the items of income, deduction, or credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

Section 1.671-4(b)(5) provides that, in general, the amounts that must be included on any Forms 1099 required to be filed by the trustee pursuant to § 1.671-4(b) do not include any amounts that are reportable by the payor on an information return other than Form 1099.

Section 1.671-4(b)(6) provides that the following trusts cannot report under § 1.671-4(b): (i) a common trust fund as defined in § 584(a); (ii) a trust that has its situs or any of its assets located outside the United States; (iii) a trust that is a qualified subchapter S trust as defined in § 1361(d)(3); (iv) a trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year; (v) a trust all of which is treated as owned by one grantor or one other person who is not a United States person; or (vi) a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.

Section 1.671-4(b)(7) provides that the trustee of a trust all of which is treated as owned by one grantor or one other person may not report pursuant to § 1.671-4(b) if the grantor or other person is an exempt recipient for information reporting purposes. The trustee of a trust, all of which is treated as owned by two or more grantors or other persons, may not report pursuant to § 1.671-4(b) if one or more grantors or other persons treated as owners are exempt recipients for information reporting purposes unless (A) at least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes and (B) the trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

Rev. Rul. 83-25, 1983-1 C.B. 116, holds that a minor will be treated, under § 677(a), as the grantor and owner of a trust created on the minor's behalf by court order for the receipt of damages awarded as a result of a personal injury suit filed on the minor's behalf.

Based solely on the facts and representations submitted, we conclude that:

1. The Trust is a grantor trust under § 671, and all of its items of income, deduction, and credit, including the sale proceeds, interest on the sale proceeds, and expenses associated with the sale proceeds, must be included in computing the taxable income of its owners.

2. The employees of X who were eligible to receive a share of the sale proceeds as of the end of Year 1 are each treated as the grantors and owners of that respective portion of the Trust that consists of each grantor and owner's pro rata share of the sale

proceeds (and applicable interest and expenses). Distribution of the sale proceeds to a grantor in a taxable year subsequent to the taxable year in which the grantor was required to include the sale proceeds in computing taxable income will have no further income tax consequences.

3. The Trust may report under the alternate method provided in § 1.671-4(b)(3) by filing Forms 1099 reporting each type of income in the aggregate, and each item of gross proceeds separately. The Trust must furnish to each grantor a statement meeting all requirements of § 1.671-4(b)(3), including reporting separately to each grantor that grantor's share of the gross interest income of the Trust on the sale proceeds and the deductible expenses of the Trust.

4. The grantors had a zero basis in their respective shares of the assets of Trust, including the demutualization proceeds. On the sale of the demutualization proceeds, the grantors realized capital gain in the amount of the sale proceeds to which each grantor was entitled. Each grantor's gain on the sale is long-term capital gain, because each grantor receiving a distribution was a participant in the Plans as of the end of Year 1, which is more than one year before the date of the sale of the New Company stock in Month of Year 2.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the transactions described above. In particular, no opinion is expressed or implied concerning the method of selection of the participants who received distributions from the Trust or the formula used to determine the amount of any participant's portion of the Trust assets.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X'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
Copy for § 6110 purposes