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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR JOYCE M. MARR
ATTORNEY CC:LM:CTM:LN

FROM: Carolyn Hinchman Gray
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SUBJECT: Trust Issues

This Chief Counsel Advice responds to your memorandum dated May 3, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Trust =
Franchiser 1 =
Franchiser 2 =
Franchiser 3 =
Subsidiary 1 =
Subsidiary 2 =

Advisors =
$ A =
$ B =
$ C =
$ D =
% A =
% B =
% C =
#1 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =

Date 5	=
Date 6	=
Date 7	=
Date 8	=
Year 1	=
Year 2	=
Year 3	=
Limited Partnership	=
Group	=
Corporation 1	=
Corporation 2	=
Bank 1	=

ISSUES

1) What is the proper pre-check the box classification of Trust for federal tax purposes?

2) If Trust is an association taxable as a corporation, may it file a consolidated return as the parent of a consolidated group?

3) Was Corporation 2's acquisition of the Brokerage Units' stock from Trust a "purchase" within the meaning of Internal Revenue Code § 338(h)(3), and thus a "qualified stock purchase" (QSP) under § 338(d)(3)?

4) Did Trust properly determine the basis of property received from Limited Partnership?

5) Should the $ A received by Trust be treated as gross income to Trust in order to avoid a potential whipsaw to the government? If so, is it includible in gross income in Year 2 or Year 3?

CONCLUSIONS

Additional information is needed to resolve these issues; however, the basic law applicable to these issues follows:

1) Section 301.7701-3(h)(2) of the Procedure and Administration Regulations provides that for certain business entities that were in existence prior to January 1, 1997, the entity's claimed classification will be respected for all periods before January 1, 1997 if the entity had a reasonable basis (within the meaning of § 6662) for its claimed classification.

2) In general, a trust that is treated as a corporation for tax purposes qualifies as an includible corporation under §1504(b) and may join in filing a

consolidated return with an affiliated group of corporations. If such a trust is at the highest tier in the chain of affiliated corporations, it would be the common parent.

3) This issue turns on the relationship between Trust and Taxpayer, with Taxpayer owning % C of Corporation 2. If Trust was affiliated with Taxpayer, the acquisition would not be a QSP.

4 & 5) Trust's basis in the Brokerage Units and whether the $ A payment from the Taxpayer group is gross income to Trust are issues that depend on how Trust is classified for federal income tax purposes and who its owners are determined to be.

FACTS

Taxpayer wholly owns Franchiser 1, Franchiser 2, and Franchiser 3 (collectively, the Franchisers). On Date 1, Taxpayer entered into the following transactions: Taxpayer formed a wholly-owned subsidiary, Subsidiary 1. Subsidiary 1 was merged into Corporation 1, with Corporation 1 continuing as the surviving corporation. Taxpayer acquired 100% of Corporation 1's stock through this merger and treated this acquisition as a deemed asset acquisition under § 338. Corporation 1 had #1 real estate brokerage offices, (collectively, the Brokerage Units). Each Brokerage Unit manages hundreds of offices conducting real estate brokerage, leasing, management and real estate related services in the residential real estate market. Corporation 1 then contributed the stock of the Brokerage Units to a newly formed subsidiary, Subsidiary 2, in a purported § 351 transaction. The Brokerage Units' properties, plants and equipment were retained by Corporation 1.

Corporation 1's claimed basis in the Brokerage Units was $ B. Also on the same day, Taxpayer and one of its subsidiaries formed Limited Partnership with Taxpayer holding a 99% capital interest and a 100% profits interest and its subsidiary, the general partner, holding a 1% capital interest. Limited Partnership immediately formed Trust. Corporation 1 then transferred all Subsidiary 2 stock to Limited Partnership, which in turn, on the same day, Date 1, assigned the Subsidiary 2 stock to the Trustees of Trust.[1] Limited Partnership deducted its $ B tax basis in the Brokerage Units as advertising and selling expenses. Limited Partnership reported no income and no other deductions on its Partnership Tax Return for its taxable year ended Date 2, and accordingly, it reported an ordinary loss of $ B. Trust recorded the basis of the Brokerage Units as $ B, the same basis that Corporation 1 had in the Brokerage Units.

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[1]It is not clear from the facts presented how Corporation 1 characterizes the transfer.

Trust was purportedly formed to benefit Taxpayer's wholly-owned Franchisers by using its revenue to promote each of the Franchisers' National Advertising Funds (NAFs). Through the Brokerage Units, Trust generates revenue by operating the network of the Brokerage Units' offices. The purpose of Trust is to operate, manage and invest the Trust Estate, including by operating, acquiring, and disposing of residential real estate brokerages, so as to produce cash flow to be spent in the Trustees' discretion to benefit the Franchisers. Moreover, the Trustees have the authority to engage in activities to increase the revenues of, and promote the interests of, the Franchisers through advertising, marketing and promotional activities and to transfer, assign or otherwise dispose of all or any part of the Trust Estate. The Trustees also have the power to manage and conduct the operations of the Brokerage Units directly and/or through employees or agents of Trust, to enter into, rescind or modify any contract affecting Trust or the Trust Estate, to appoint the directors of any entity which holds all or any part of the Trust Estate, to borrow money for the purpose of operating the Trust Estate, to acquire additional property, and to hire (and fire) such agents, officers, employees, auditors, attorneys, financial advisors, real estate brokers, consultants and investment counselors as determined reasonable or necessary by the Trustees to manage the day to day operations of the Trust Estate and to pay them reasonable compensation as determined by the Trustees. Trust provides that any "Excess Cash" is first to be used to reimburse Trustees, and second, to be distributed to the Franchisers' NAFs. However, the Trustees are not required to make regular distributions to the NAFs and any "Excess Cash" not to be distributed by the Trustees is to be added to the Trust Estate. Trust is to continue until 90 days after the earliest date of: (a) the distribution of the Trust Estate; (b) Date 2; or (c) the longest period that it can exist under New York law.

Trust entered into franchise agreements with the Franchisers on behalf of each of the Brokerage Units. However, under the franchise agreements, Trust could not open or acquire any more offices for the Brokerage Units without the approval of the Franchiser and the Franchiser had the right of first refusal in the sale or transfer of any of the Brokerage Units' offices. Under the franchise agreements, Trust was required to pay the Franchiser a continuing royalty in the amount equal to a fixed percent of the gross revenues generated by the Brokerage Units' offices. In addition, the Brokerage Units' offices were required to make monthly contributions in amounts that range from % A to % B of gross commission revenue to the Franchiser's NAF.

In addition, Taxpayer and its subsidiaries entered into other agreements with Trust. Trust leased its office facilities from Taxpayer and entered into an Indemnification Agreement, a Call Agreement, an Asset Management Agreement and a Support Agreement with Taxpayer and its subsidiaries. The Indemnification Agreement provided that Corporation 1 would indemnify Trust with respect to certain legal proceedings against the Brokerage Units contributed to Trust. The Call Agreement provided that Taxpayer may purchase the Trust Estate at its fair

market value in the event of a change in law or accounting principle that would require the Trust Estate to be consolidated with Taxpayer. The Asset Management Agreement provided that Trust would assist and oversee the leasing and management of certain properties the ownership of which was retained by Corporation 1. The Support Agreement provided that Trust would pay a fee to Taxpayer for certain data processing and telecommunication services.

From Date 4 to Date 5, Trust acquired various corporations involved in the real estate market. To finance these acquisitions, Trust received a $ A loan from Taxpayer, received loans from the Franchisers, and entered into a $ C revolving credit agreement with Bank 1. Trust used $ D in its revolving credit agreement with Bank 1. On Date 6, Taxpayer and a group of limited partnerships (Group) formed Corporation 2 in a § 351 exchange. Trust then sold the stock of the Brokerage Units to Corporation 2 in a transaction treated as a purchase of assets pursuant to § 338(h)(10). Upon acquisition of the Brokerage Units, Corporation 2 also leased its office facilities from Taxpayer and entered into the same agreements previously held by Trust and Taxpayer. The franchise agreements entered into by Corporation 2 and the Franchisers granted the Franchisers more royalties and powers than the franchise agreements between Trust and Franchisers. After this acquisition, Taxpayer transferred $ A to Trust by a check dated Date 7. Trust, an accrual basis taxpayer, deposited the check to its bank account on Date 8. Taxpayer took a deduction for this contribution to Trust. During Year 2 and Year 3, Corporation 2 acquired numerous real estate brokerages from Taxpayer.

LAW AND ANALYSIS

Issue 1

Trust was formed Date 1, and since its formation has filed as an association taxable as a corporation. Effective January 1, 1997, the "check-the-box" regulations determine the classification of an entity. Treasury Regulation § 301.7701-3(h)(2) provides that for certain business entities that were in existence prior to January 1, 1997, the entity's claimed classification will be respected for all periods before January 1, 1997, if (i) the entity had a reasonable basis (within the meaning of § 6662) for its claimed classification; (ii) the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months before January 1, 1997; and (iii) neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination). The facts presented do not address Treas. Reg. § 301.7701-3(h)(2)(ii) and (iii). Therefore, assuming that these requirements are satisfied, Trust's classification depends upon whether Trust had a reasonable basis for its claimed classification as a corporation. Treas. Reg. § 301.7701-3(h)(2)(i).

The determination of whether a trust is to be treated as a trust or as an association depends upon whether there are associates and an objective to carry on business and divide the gains therefrom. Pre-1997 Treas. Regs. § 301.7701-2(a)(2). Once it is established that Trust has associates and an objective to carry on a business and divide the gains therefrom, Trust must have a preponderance of the following corporate characteristics to be classified as an association taxable as a corporation: (1) continuity of life, (2) centralization of management, (3) liability of corporate debts limited to corporate property; and (4) free transferability of interests. Pre-1997 Treas. Regs. § 301.7701-2(a)(1). We are unable to determine whether Trust's classification as an association is reasonable because the facts presented do not enable us to identify Trust's associates. The Trust Instrument does not identify Trust's associates and Trust's position as to the identity of its associates must be obtained to determine if Trust's classification is reasonable.

Issue 2

In general, a trust that is treated as a corporation for tax purposes qualifies as an includible corporation under §1504(b) and may join in filing a consolidated return with an affiliated group of corporations. If such a trust is at the highest tier in the chain of affiliated corporations, it would be the common parent.

In the instant case, Trust appears at first glance to be the highest corporation in a chain of affiliated corporations. However, we need additional information to determine whether Trust may file as the common parent of a consolidated group.

This issue turns on the identity of Trust's associates. Because Trust determined in the year it was formed that it was an association taxable as a corporation, it apparently concluded that it had associates. Although the facts submitted present a compelling case for treating the NAFs, which were members of the Taxpayer's group, as Trust's associates, we are interested in Trust's position on the identity of its associates and on the operation of Trust.

Issue 3

We do not have sufficient information to determine whether the acquisition of the Brokerages Units by Corporation 2 was a QSP within the meaning of § 338. This issue turns on the relationship between Trust and Taxpayer, with Taxpayer owning % C of Corporation 2. If Trust was affiliated with Taxpayer, the acquisition

would not be a QSP. More information is needed regarding the identity of Trust's associates which is relevant to the determination of Trust's relationship to Taxpayer.

Issues 4 & 5

Trust's basis in the Brokerage Units and whether the $ A payment from the Taxpayer group is gross income to Trust are issues that depend on how Trust is classified for federal income tax purposes and who its owners are determined to be. Additional information is needed to make these determinations. In the interim, we set forth our tentative conclusions.

Trust resembles the entity that was the subject of Rev. Rul. 74-318, 1974-2 C.B. 14. In that ruling, the Service concluded that a nonprofit corporation established to collect contributions from automobile dealer franchisees and the manufacturer and expend its funds for advertising and marketing purposes was taxable as a corporation, that contributions were gross income to the corporation, and that the corporation could deduct its expenditures subject to the limitations of § 277 (limiting deductions to income from members). See also Rev. Rul. 74-319, 1974-2 C.B. 15.

We believe the same treatment should apply to Trust, as it serves substantially the same purpose as the entity in the ruling and is funded in a similar manner. Trust differs from the entity described in the ruling in that Trust received stock in the Brokerage Units as well as cash. But arguably, the nature of the asset(s) contributed to such an entity should not alter the tax treatment of the contributions. Accordingly, the Year 1 transfer of stock in the Brokerage Units should result in gross income to Trust equal to the fair market value of the stock, with Trust obtaining, as a result, basis in the stock in the same amount.[2] Similarly, the $ A payment should result in gross income to Trust in Year 2 or Year 3, according to which is the proper year for inclusion under Trust's method of accounting.

We understand the conclusion of Rev. Rul. 74-318, on which we base our tentative reply, is inconsistent with Ford Dealers Advertising Fund, Inc. v. Commissioner, 55 T.C. 761 (1971), nonacq., 1974-2 C.B. 5, aff'd per curiam, 456 F.2d 255 (5th Cir. 1972), and other cases finding that entities similar to Trust do not have income as a result of contributions from members because of restrictions on the entities' discretion in expending contributed funds. But we note that the

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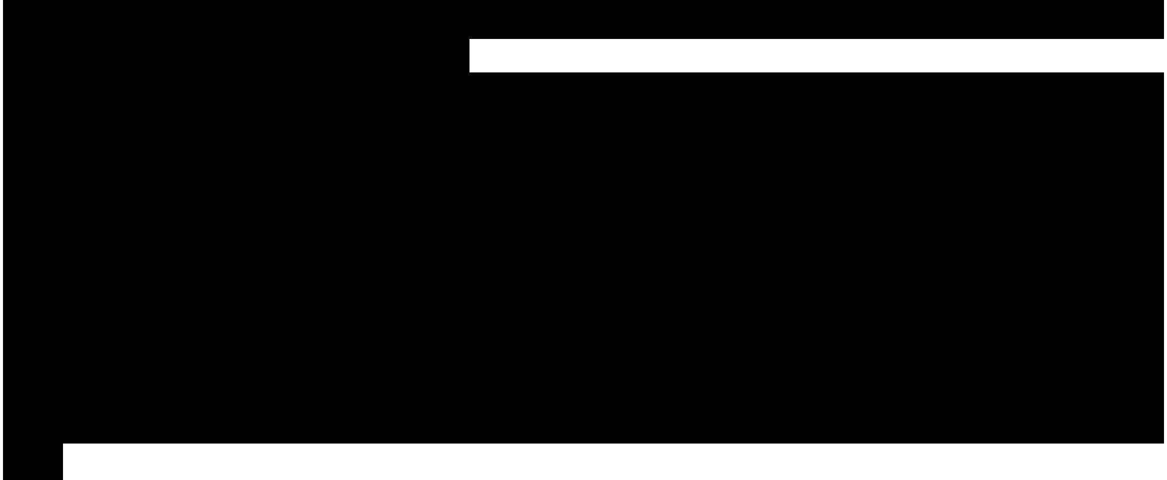
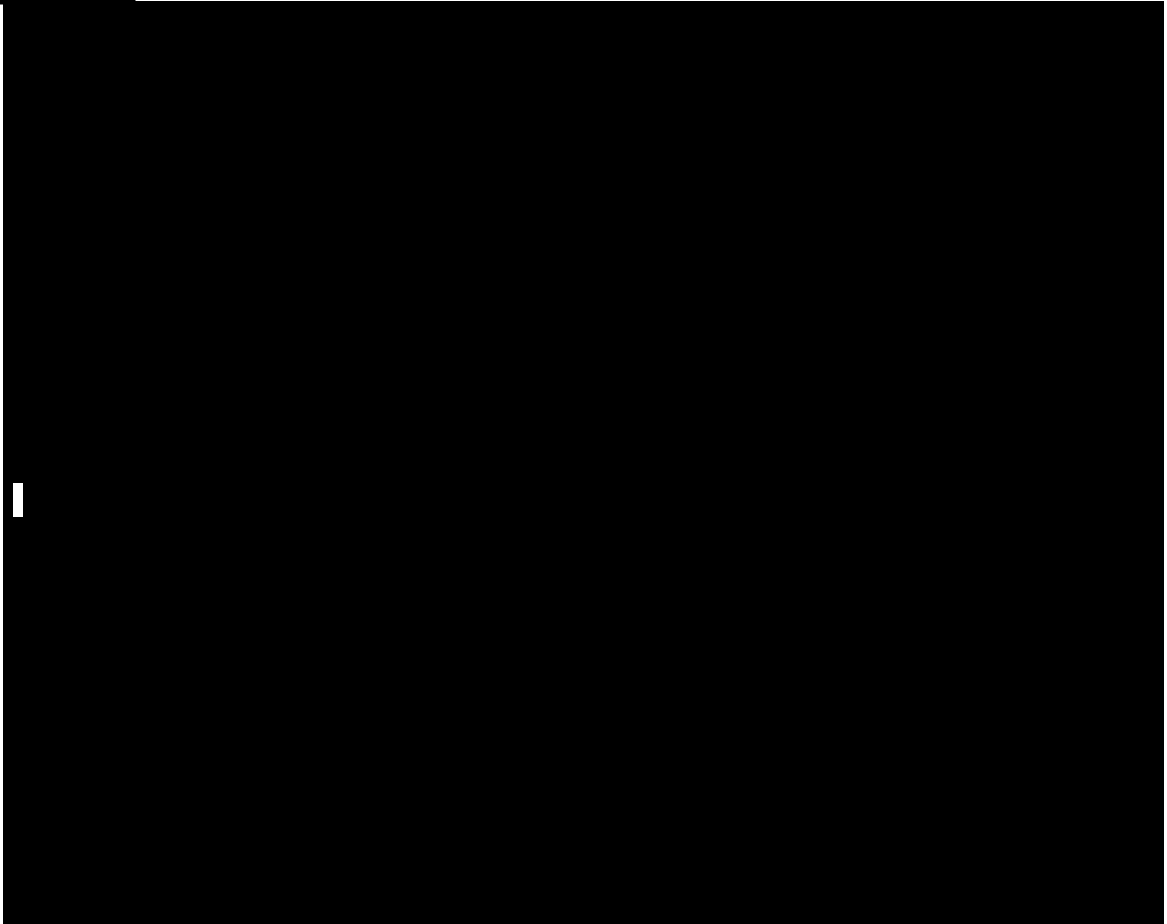
[2]Whether that fair value is approximately $ B as claimed is a factual issue that should be resolved. Another possible issue arises if the partnership's basis in the stock differed from its fair market value, in which case there could be gain or loss recognized on the transfer.

Service's published opinion is to the contrary. Moreover, in this case, Trust itself took the position that it received the stock in the Brokerage Units not as a conduit, but in its own right, as it reported gain when it disposed of the stock in a separate transaction in Year 2. And Trust has filed corporate income tax returns. Finally, the deduction by Taxpayer's group of approximately $ B in Year 1 as a result of the stock transfer to Trust and $ A as a result of the cash payment to Trust are both inconsistent with treatment of Trust as a conduit.

CASE DEVELOPMENT





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Please call if you have any further questions.

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