Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:02 – PLR-166266-03

Date:
April 22, 2005

Legend:

X =

Trust 1 =

Trust 2 =

LLC =

State =

Date 1 =

Date 2 =

Dear

This responds to your letter dated November 3, 2003, and subsequent correspondence, submitted on behalf of X, Trust 1, Trust 2, and LLC, as their authorized representative, requesting rulings on several issues arising from agreements entered into among the parties.

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 to Alaska Native Corporations (ANC) established by qualified Alaska natives as compensation. The ANCSA provided that all United States citizens with ¼ 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 in one of the twelve regional corporations and in one local village corporation created under the ANCSA 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The ANCSA, as originally enacted, provided that for a period of 20 years after December 18, 1971, the stock, inchoate rights thereto, and any dividends paid or distributions made with respect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 intervivos gift to certain family members. The ANCSA also provides 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 twenty-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 USC 1629c. If the shareholders vote to terminate the alienation restrictions on the stock, all settlement common stock is cancelled as a matter of law and is replaced with unrestricted replacement common stock. 43 USC 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 ANCSA Amendments of 1987 authorizes the conveyance of certain assets of an ANC to a state-chartered settlement trust (Settlement Trust). The general purpose of the 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 Settlement Trust is to be used to insulate permanently land, as well as other assets transferred to it, from the

business risks undertaken by the ANC. Such Settlement 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 USC 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 USC 1629b(a)(3) and 1629b(b). The shareholders, however, are not required to approve the conveyance of any assets by the corporation to the Settlement Trust unless all or substantially all of the assets of the corporation are to be conveyed. 43 USC 1629e(a)(1)(B).

Section 646 of the Internal Revenue Code was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. Section 646 addresses several aspects concerning the tax treatment of Settlement Trusts.

FACTS

The information submitted states that X is organized as an ANC under the provisions of ANCSA and Alaska state law. In Date 1, X established Trust 1, a Settlement Trust, to provide long-term pro-rata cash distributions to its shareholders. Trust 1 is in operation and has been making such distributions for approximately a decade.

In Date 2, X established Trust 2, a Settlement Trust, to provide non pro-rata educational and funeral benefits to its shareholders.

To facilitate and coordinate the investments of X, Trust 1, Trust 2, and their wholly owned entities, X established LLC under State law as a limited liability company. Interests in LLC are divided into Units. X, Trust 1 and Trust 2 are the current unitholders of LLC. Only X, Trust 1, and Trust 2, or any entity wholly owned by any of them may own Units in LLC.

Under the LLC agreement, items are allocated to the unitholders in proportion to their respective Units. Each unitholder will have the same number of Units as they have dollars in their capital account based upon contributions, distributions, and redemptions. Under the LLC's operating agreement there will be one or more "Allocation Periods" within each year that will be the basis upon which various items are allocated among the unitholders. An Allocation Period is created each time a unitholder's capital account balance changes (e.g., due to capital contributions, redemptions, or distributions). In addition, a new Allocation Period begins each January 1.

X has historically rendered various administrative services to Trust 1 and Trust 2, such as accounting, tax reporting, maintaining record lists of owners and/or beneficiaries, and other books and records, and facilitating the meetings of the fiduciaries of each respective entity, free of charge.

X proposes to enter into Service Agreements with Trust 1, Trust 2, and LLC under which X will be paid a fee for such administrative services. Each Service Agreement provides an annual service fee. The amount paid under each Service Agreement to X is computed by combining identified percentages of X's expenditures in each of several categories of general and administrative costs. The fee is to be paid December 15 each year; however, the Service Agreements contain a mechanism by which the annual fee charged by X may be adjusted downward (but not upwards) each year after Trust 1, Trust 2 and LLC each evaluate the cost of services X actually rendered. X must present a cost analysis to Trust 1, Trust 2 and LLC by December 1 of the contract year that will evaluate the annual fee in terms of whether the fee has been fair for all parties. On or before December 15, to the extent the parties determine that the annual fee overcompensates X, the fee will be reduced dollar for dollar. The fee may not be increased if the parties determine that X has been undercompensated. The Trustees of Trust 1 and Trust 2 must approve the respective Service Agreements concerning the Trusts. In addition, under the Trust Agreements for Trust 1 and Trust 2, the Trustees must direct the investments of each Trust and vote the securities in their fiduciary capacity.

Trust 1 and Trust 2 have made an election under § 646.

X has received two private letter rulings (PLR 9329026 and PLR 9824014) pertaining to Trust 1 and Trust 2. X represents that all the representations set forth in those prior letter rulings remain true and correct.

LAW AND ANALYSIS

Under § 301.7701-1 of the Procedure and Administration Regulations, whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership.

Section 301.7701-3(b)(1)(i) provides that unless a domestic eligible entity elects otherwise it is a partnership if it has two or more members.

Based on the facts and circumstances of this case, LLC is an eligible entity separate from its owners, and is classified as a partnership for federal tax purposes as provided in § 301.7701-3(b).

A Settlement Trust may elect to have the provisions of § 646 apply to the trust and its beneficiaries. 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.

Section 671 provides 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 679 specify the circumstances under which the grantor or another person will be regarded as the owner of a portion of a trust. Based on our examination of the Service Agreements we conclude that the Service Agreements do not cause X or another person to be treated as the owner of any portion of the trusts under §§ 673, 674, 676, 677, 678, or 679.

Section 675 provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the grantor has certain administrative powers.

Section 675(1) provides that the grantor of a trust shall be treated as the owner of any portion of the trust in respect of which a power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

Section 675(4) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of § 675(4), the term "power of administration" includes: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control and (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.

You ask for a ruling as to whether the Service Agreements between X and Trust 1 and Trust 2 cause X to be treated as an owner of any portion of Trust 1 or Trust 2 under § 675(1); more specifically, whether X has a power to deal with either trust "for less than adequate consideration." X represents that the fees paid by Trusts to X for the administrative services provided to Trusts represent Trusts' share of actual amounts that X pays to independent third parties for such services. In addition, under the Service Agreements, X will itself incur costs with respect to "Operational Support Services" (e.g., providing private office and meeting space, use of office equipment, etc.) provided to Trusts. Thus, the fees are more in the nature of reimbursements paid by Trusts to X, with respect to payments made to third parties and for costs incurred by X that benefit Trusts. X represents that the percentage of X's total costs assigned to each Trust by X will be a reasonable amount given the value that each trust receives from the particular services in question.

We conclude that the mechanism of providing administrative services by X to Trusts pursuant to the Service Agreements and the payment of the fees by the Trusts to X does not in and of itself cause X to have the power to deal with each Trust "for less than an adequate consideration" for purposes of § 675(1). However, no opinion is expressed or implied as to whether the expenses incurred by X are reasonable or represent fair value, nor whether the percentage of those expenses allocated to Trust 1 or Trust 2 is appropriate for purposes of § 675(1).

You also ask for a ruling as to whether the Service Agreements between X and Trust 1 and Trust 2 cause X to be treated as an owner of any portion of Trust 1 or Trust 2 under § 675(4)(A) and (B); more specifically, (A) whether there is a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of X and Trusts are significant from the viewpoint of voting control and (B) whether X has the power to control the investment of the Trusts funds. The Service Agreements do not grant X a power to vote stock or securities of any entity in which Trust 1 or Trust 2 holds a significant interest. Nor do the Service Agreements grant X a power to direct or veto Trust 1 or Trust 2 investments. Therefore, we conclude that entering the Service Agreements with Trust 1 and Trust 2 will not cause X to be treated as an owner under § 675(4)(A) or (B). In addition, our examination of the Service Agreements between X and Trust 1 and Trust 2 reveal none of the circumstances that would cause X or another person to be treated as the owner of any portion of the trusts under § 675. However, the circumstances attendant on the operation of Trust 1 and Trust 2 will determine whether X will be treated as the owner of any portion of the Trusts under § 675. This is a question of fact, the determination of which must be made by the Office of the Area Director with which the trusts file their tax returns.

You ask for a ruling as to whether the Service Agreement between X and LLC cause X to be treated as an owner of any portion of Trust 1 or Trust 2 under § 675(1); more specifically, whether payment of fees by LLC to X removes income that would otherwise be allocated to the Trusts, thereby granting X a power to deal with Trusts "for less than adequate consideration." X represents that the fee paid by LLC to X for the

administrative services provided to LLC represent LLC's share of actual amounts that X pays to independent third parties for such services. In addition, under the Service Agreement, X will itself incur costs with respect to "Operational Support Services" (e.g., providing private office and meeting space, use of office equipment, etc.) provided to LLC. Thus, the fees are more in the nature of reimbursements paid by LLC to X, with respect to payments made to third parties and for costs incurred by X that benefits LLC. X represents that the percentage of X's total costs assigned to LLC by X will be a reasonable amount given the value that LLC receives from the particular services in question.

We conclude that the mechanism of providing administrative services by X to LLC pursuant to the Service Agreement and the payment of the fee by the LLC to X does not in and of itself cause X to have the power to deal with each Trust "for less than an adequate consideration" for purposes of § 675(1). However, no opinion is expressed or implied as to whether the expenses incurred by X are reasonable or represent fair value, nor whether the percentage of those expenses allocated to LLC is appropriate for purposes of § 675(1).

You also ask for a ruling as to whether the Service Agreement between X and LLC causes X to be treated as an owner of any portion of Trust 1 or Trust 2 under § 675(4)(A) and (B); more specifically, (A) whether there is a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of X and Trusts are significant from the viewpoint of voting control and (B) whether X has the power to control the investment of the Trusts funds. The Service Agreement does not grant X a power to vote stock or securities of any entity in which Trust 1 or Trust 2 holds a significant interest. Nor does the Service Agreement grant X a power to direct or veto Trust 1 or Trust 2 investments. Therefore, we conclude that entering the Service Agreement with LLC will not cause X to be treated as an owner of Trust 1 or Trust 2 under § 675(4)(A) or (B). In addition, our examination of the Service Agreement between X and LLC reveal none of the circumstances that would cause X or another person to be treated as the owner of any portion of the Trusts under § 675. However, the circumstances attendant on the operation of Trust 1, Trust 2 and LLC will determine whether X will be treated as the owner of any portion of the Trusts under § 675. This is a question of fact, the determination of which must be made by the Office of the Area Director with which the trusts file their tax returns.

Section 704(c) provides that income, gain, loss and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of the contribution.

You ask for a ruling as to whether the method of allocation of LLC causes X to be treated as an owner of any portion of Trust 1 or Trust 2. Under the LLC agreement submitted, items are allocated to the unitholders in proportion to their respective units. The LLC agreement also provides that income, gain, loss and deduction with respect to property contributed will be shared among the unitholders so as to take account of the

variation between the basis of the property to the partnership and its fair market value at the time of the contribution as provided by § 704(c). Because the items are allocated according to the unitholders' respective interests in the LLC, no unitholder will receive an allocation that could be construed to grant it a right to income which would cause X to be considered an owner of Trust 1 and Trust 2. Based on our examination of LLC's method of allocation we conclude that the method does not cause X or another person to be treated as the owner of any portion of the trusts under §§ 673, 674, 676, 677, 678, or 679. Additionally, our examination of LLC's method of allocation revealed none of the circumstances that would cause X or another person to be treated as the owner of any portion of the trusts under § 675. However, the circumstances attendant on the operation of Trust 1, Trust 2, LLC, and X will determine whether X will be treated as the owner of any portion of the Trusts under § 675. This is a question of fact, the determination of which must be made by the Office of the Area Director with which the trusts file their tax returns.

Section 61(a) provides that gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. X proposes to enter into Service Agreements with Trust 1, Trust 2, and LLC under which X will be paid a fee for such administrative services. Each Service Agreement provides an annual service fee (the contract fee). Additionally, the Service Agreements provide that on or before December 1 of the contract year, X will provide an analysis that will evaluate the fee. To the extent the parties determine that the contract fee was overstated, the fee will be reduced. Then, on or before December 15 of the contract year, X will receive a one-time fee for the services provided to Trust 1, Trust 2 and LLC. The difference between the original contract fee and the reduced fee is not income to X provided that Trust 1, Trust 2 and LLC do not deduct that difference.

Under § 448(a)(2), LLC is prohibited from computing its taxable income using the cash receipts and disbursements method of accounting.

RULINGS

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. LLC is an eligible entity separate from its owners, and is classified as a partnership for federal tax purposes as provided in § 301.7701-3(b).

2. The fact that Trust 1, Trust 2, and LLC will pay X for expenses properly allocable to Trust 1, Trust 2, and LLC for services under the Service Agreements will not per se cause X to be treated for federal income tax purposes as the owner of Trust 1 or Trust 2 (or any portion of Trust 1 or Trust 2) under the grantor trust rules of §§ 671-679. No opinion is expressed as to whether the expenses allocated to Trust 1, Trust 2, and LLC are appropriate.

3. Allocations of LLC's items of income, gain, loss, deduction, or credit in proportion to the unitholder's respective units as provided in the LLC agreement, or as required by § 704(c), will not cause X or any other person to be treated for federal tax purposes as the owner of Trust 1 or Trust 2, (or any portion of Trust 1 or Trust 2) under the grantor trust rules of §§ 671-679. No opinion is expressed as to the validity of LLC's chosen method of allocation under § 704(b).

4. The difference between the original fee provided for in the Service Agreements and the reduced fee (if any) agreed to by X, Trust 1, Trust 2, and LLC is not income to X. This ruling is premised on Trust 1, Trust 2, and LLC not deducting the difference (if any) between the original fee and the reduced fee.

5. Based solely on the information submitted, and the representation that the facts and representations in the prior letter rulings remain true and correct, we rule that the transactions set forth above have no effect on PLR 9329026 and PLR 9824014 and such rulings will remain in full force and effect, subject to the extent of any conditions stated in those letter rulings.

6. The Service Agreements do not affect the § 646 elections of Trust 1 and Trust 2.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and Income Tax Regulations other than those expressed in the prior letter rulings, or about the tax treatment of any conditions existing at the time, or effects resulting from, the proposed transaction that are not specifically covered by the above ruling or those rulings set forth in the prior letter rulings.

A copy of the letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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.

Sincerely,

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

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