

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Associate Area Counsel
CC:SB:4CHI:1
(Small Business/Self-Employed)

from: Senior Counsel
CC:PSI:02
(Passthroughs & Special Industries)

subject: Application of Grantor Trust Rules and Ownership Attribution Rules of §§ 267 and 707(b)(1)(A)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

LLC =

A =

B =

C =

D =

E =

F =

M =

N =

O =

X =

Y =

Z =

Trust1 =
Trust2 =
Trust3 =
Trust4 =
Trust5 =
Trust6 =
Trust7 =
Trust8 =
Trust9 =
Trust10 =
Date =
n1 =
n2 =
n3 =
n4 =
n5 =
n6 =
n7 =
n8 =
n9 =
n10 =

ISSUES

- 1) Whether grantor trusts are disregarded as entities separate from their owners for all federal income tax purposes, including §§ 267 and 707(b)(1)(A)?
- 2) Whether a short-term capital loss that was recognized upon the sale of partnership property to certain grantor trusts, under the facts described below, may be disallowed under §§ 267 and/or 707(b)(1)(A)?
- 3) Whether a short-term capital loss that was recognized upon the sale of partnership property to certain grantor trusts, under the facts described below, may be disallowed under § 165?

CONCLUSIONS

1. Yes. Grantor trusts are disregarded as entities separate from their owners for all federal income tax purposes, including §§ 267 and 707(b)(1)(A).
2. Yes. A short-term capital loss that was recognized upon the sale of partnership property to certain grantor trusts, under the facts described below, may be disallowed under §§ 267 and/or 707(b)(1)(A).
3. No. A short-term capital loss that was recognized upon the sale of partnership property to certain grantor trusts, under the facts described below, may not be disallowed under § 165.

FACTS

Ownership Structure of LLC

LLC is a limited liability company owned by X, M and N. X owns n1%, M owns n2%, and N owns n3% of the capital and profits interests of LLC. X is an S corporation owned by Y and Z. Y is a grantor trust of A, the beneficiaries of which include A, A's descendants, and Z. Z is A's foundation and is the residuary beneficiary of Y with no claim to Y's trust estate until the deaths of A and A's descendants. M and N are both partnerships for federal income tax purposes. M is equally owned by three irrevocable trusts, Trust1, Trust2, and Trust3. N is owned by the following four trusts (and in the following percentages): Trust4 (n4%), Trust5 (n5%), Trust6 (n6%), and Trust7 (n7%).

Trust1, Trust2 and Trust3 are irrevocable complex trusts whose beneficiaries are A, one named child (B, C or D) of A, and the child's spouse and descendants, respectively. Trust4, Trust5 and Trust6 are also irrevocable trusts, the grantor of which was A's father and whose beneficiaries are A and one named child (B, C or D) of A, respectively. Trust7 is an irrevocable trust, the grantor of which was A's father and whose beneficiaries are A and the grandchildren of A. Trust1, Trust2, Trust3, Trust4, Trust5, Trust6, and Trust7 are collectively referred to as the "Selling Trusts".

Transaction

On or about Date, LLC sold its member interests in E and F to Trust8, Trust9 and Trust10 (collectively referred to as the "Purchasing Trusts") in equal portions. LLC reported a short-term capital loss of \$n8 on the sale of its interest in E and a short-term capital loss of \$n9 on the sale of its interest in F. The Purchasing Trusts are represented as being irrevocable grantor trusts for federal income tax purposes, with one of A's children (B, C, or D) being the grantor of each trust, respectively, and the beneficiaries of each trust being the respective grantor's descendants. The grantor of each Purchasing Trust has the power to reacquire the trust corpus by substituting other property of an equivalent value, as described in § 675(4)(C).

The trustee of each of the Selling Trusts, Purchasing Trusts, and Y at the time of the transaction was O, a limited liability company owned by three irrevocable trusts, each of which is for the benefit of one of A's children (B, C or D) and for which A is the grantor.

E and F are both treated as partnerships for federal income tax purposes. E and F held publicly-traded stocks and bonds as well as private investments (interests in related entities, partnerships, etc). E and F do not appear to hold any real estate.

Examination's Position

Examination has taken the preliminary position that the claimed losses are disallowed under § 707(b)(1)(A) because the losses were generated from property dispositions by a partnership (the LLC) to persons owning more than 50 percent of the partnership, namely B, C, and D, as individuals. This is accomplished through the use of the attribution rules of § 267(c) (with B, C and D treated as indirect owners of interests in the LLC) and their deemed roles as the purchasers of the partnership property (as a result of their status as grantors and owners of the Purchasing Trusts). With respect to the ownership of the LLC, Examination takes the position that the specifically named beneficiaries of the Selling Trusts should be treated as equal owners and, by applying the attribution rules of § 267(c), each of B, C, and D own more than 50 percent of the LLC. Examination also notes that, based on the pattern of distributions of the Selling Trusts (the distributions of which mostly went to A), A should be treated as owning more than n10 percent of the LLC. Under the attribution rules of § 267, B, C, and D would then *each* be treated as owning more than n10 percent of the LLC (in addition to the portion they own directly).

Examination also takes the position that, because the Purchasing Trusts are grantor trusts under § 675(4)(C), B, C, and D, as individuals, should be treated as the purchasers of the partnership property. Therefore, the claimed loss should be disallowed under § 707(b)(1)(A) because the loss was generated by a sale of assets by the LLC to its partners, B, C, and D, each of whom own more than 50 percent of the interests in the LLC through the § 267(c) attribution rules.

Examination has also requested advice whether the claimed loss may be disallowed in this case under § 165 as either an alternative argument or as the primary argument in the event that we advise that the loss cannot be disallowed under § 267 or § 707(b)(1)(A).

LAW

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Under § 1.165-1(b) of the Income Tax Regulations, a deductible loss must be evidenced by closed and completed transactions, fixed by identifiable events and actually sustained during the tax year. Only a bona fide loss is allowed. Substance, and not form, governs in determining a deductible loss.

Section 267(a)(1) provides, in pertinent part, that no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in § 267(b).

Section 267(b) provides, in pertinent part, that the persons specified in § 267(a) are: (1) members of a family, as defined in § 267(c)(4); (4) a grantor and a fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust, if the same person is the grantor of both trusts; (6) a fiduciary of a trust and a beneficiary of such trust; and (7) a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.

Section 267(c) provides that for purposes determining, in applying § 267(b), the ownership of stock –

(1) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

...

(4) the family of an individual shall include only his brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants; and

(5) stock constructively owned by a person by reason of the application of § 267(c)(1) shall, for the purposes of applying §§ 267(c)(1), (2) or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of §§ 267(c)(2) or (3) shall not be treated as owned by him for the purpose of

again applying either of such paragraphs in order to make another the constructive owner of such stock.

Section 707(b)(1)(A) provides that no deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in a partnership), directly or indirectly, between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership (emphasis added).

Section 707(b)(3) provides that, for purposes of § 707(b)(1), the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules of constructive ownership of stock provided in § 267(c) other than § 267(c)(3).

Section 1.707-1(b)(1) provides, in pertinent part, that no deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership), directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership (emphasis added).¹

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 which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control under § 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

Section 675(4) provides, in pertinent part, 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 this paragraph, the term “power of administration means . . . (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 1.671-2(a) provides that under § 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of

¹ It should be noted that § 1812(c)(3)(A) of P.L. 99-514 (1986) amended § 707(b)(1)(A) by striking the word “partner” and replacing it with “a person” specifically to allow § 707(b) to apply whether or not the constructive owner was itself a partner. S. Rep. No. 99-313, 1986 C.B. Vol. 2 at 960. This change in language is not reflected in § 1.707-1(b), effectively making that section (or portions thereof) obsolete.

which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in § 1.671-3.

Section 1.671-2(c) provides that an item of income, deduction, or credit included in computing the taxable income and credits of a grantor trust or another person under § 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which attributed to the grantor (an individual) under §§ 671 through 679 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of § 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of § 904 with respect to credit for tax paid to that country.

Section 1.671-3(a)(1) provides that when a grantor or another person is treated under subpart E (§ 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example, [i]f a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

Rev. Rul. 85-13, 1985-1 C.B. 184, states that the owner of a grantor trust is not merely taxable on a trust's income, but is treated as the owner of the trust's assets for federal income tax purposes, citing Ringwald v. United States, 549 F.2d 89 (8th Cir. 1977), cert. denied, 432 U.S. 906 (1977); Estate of O'Connor v. Commissioner, 69 T.C. 165 (1977); Example 5, § 1.1001-2(c) of the regulations; Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 78-175, 1987-1 C.B. 144; Rev. Rul. 77-402, 1977-2 C.B. 222; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 72-471, 1972-2 C.B. 201; Rev. Rul. 70-376, 1970-2 C.B. 164; and Rev. Rul. 66-159, 1966-1 C.B. 162; but cf. Rev. Rul. 74-243, 1974-1 C.B. 106. Rev. Rul. 85-13 also states that the Service would not follow the decision in Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), in which the Court treated § 671 merely as an income attribution rule, otherwise treating owner and trust as separate income tax entities which could engage in taxable transactions with each other.

Rev. Rul. 85-13 reasons that it would be anomalous to suggest that Congress, in enacting the grantor trust provisions, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for the attributing items of income, deduction, and credit to the grantor

under § 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.

ANALYSIS

Ruling 1

Before determining whether B, C and D are each properly deemed to own more than 50 percent of the capital or profits of LLC under § 707(b)(1)(A) to disallow the claimed losses under that provision, we must first determine whether it is appropriate to treat B, C and D as the owners of the assets held in the Purchasing Trusts for all federal income tax purposes (including §§ 267 and 707(b)(1)(A)). This raises the threshold question of whether trusts that are subject to subpart E (the grantor trust rules of §§ 671-679) are properly disregarded as entities separate from their owners for more than mere income attribution purposes.

We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner. As Rev. Rul. 85-13 states, it would be anomalous for the existence of a grantor trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its identity as a separate entity capable of entering into a sales transaction with the owner. When a grantor or other person exercises dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the owner's benefit, the owner has treated the trust property as though it were the owner's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is consistent with and supported by the rationale for attributing items of income, deduction, and credit to the owner. Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes, including §§ 267 and 707(b)(1)(A).

Ruling 2

In determining whether § 707(b)(1)(A) applies to disallow the Taxpayer a loss on the sale of Taxpayer's interests in E and F in the instant case, it is necessary to determine whether the purchasers owned, directly or indirectly, more than 50% of the capital and profits interest in Taxpayer. The constructive ownership (attribution) rules of § 267(c) (other than § 267(c)(3)) are to be used in determining the constructive ownership interest of specific persons in Taxpayer's capital or profits interest.

Section 267(c) provides, in part, rules for attributing a beneficiary's proportionate ownership interest in stock owned by or for a trust to such beneficiary and to others (e.g., family members). However, there is nothing in the language of § 267(c) or the legislative history of § 267 that provides any guidance on how to determine a beneficiary's proportionate interest in stock owned by a trust or how to determine the "value" of a beneficiary's proportionate interest in stock owned by or for a trust for purposes of § 267. Similarly, there is nothing in the language of § 267(c) or in the legislative history of § 267 that provides any guidance on how to determine a capital or profits in a partnership or a beneficiary's proportionate interest of the capital or profits interest in a partnership that is owned by or for a trust. There also is little case law on the issue of how to "value" a beneficiary's proportionate interest in a trust under § 267(c)(1).

Although certain other provisions of the Code contain language similar or identical to that in §§ 707(b)(3) and 267(c) and have been construed by the Service or the courts (see e.g., former § 544(a)(1)), the relevance of those provisions to determinations required to be made under § 707(b)(3) in conjunction with § 267(c) is at best questionable, as the purpose for which indirect ownership is being ascertained differs in each case. For that reason, we believe that even though the Service has construed statutory language identical or similar to that in §§ 707(b)(3) and 267(c) regarding indirect ownership of stock through a trust, those analyses are unhelpful in the present inquiry regarding indirect ownership of a capital or profits interest in a partnership through a trust. Our view of the relevance of these interpretations of the same or similar language in other Code sections to the appropriate construction of § 707(b)(3) in conjunction with § 267(c) is bolstered by Hickman v. Commissioner, T.C. Memo. 1972-208.

In Hickman, the narrow issue before the court was (1) whether, under § 267(b)(2), the petitioners indirectly owned more than 50 percent of the value of Atlas Groves, Inc., all of whose stock was owned by the Mary Hickman Trust (trust), and (2) whether the method of valuing ownership of stock was computed "within the intendment of § 267(b)(2) and (c)." Petitioners, a husband and wife, were sole income beneficiaries of the trust, and the last beneficiary to die held a power of appointment to direct the corpus of the trust. The trustee held discretion to distribute income and corpus from the trust for the benefit of beneficiaries and all income not distributed to the beneficiaries was to be accumulated and added to the corpus of a separate trust held for the benefit of the surviving beneficiary.

The Commissioner's position was that petitioners owned more than 50 percent of the value of Atlas's stock because they were the only present beneficiaries of the trust and the trust named no specific remaindermen. Petitioners conceded that they had constructive ownership of the outstanding stock of Atlas held by the trust within the ambit of § 267(b) and (c), but that if the percent of value of their interest in the stock was computed by actuarial values, or alternatively by the fair market value method, they did not own the required percent under § 267(b)(2) to sustain the Commissioner's position.

Petitioners relied on Rev. Rul. 62-155, 1962-2 C.B. 132, to argue that stock ownership held indirectly through the trust should be valued on an actuarial basis. Rev. Rul. 62-155 holds that in determining stock ownership for the purposes of §§ 421(d)(1)(C) and 544(a)(1) of the 1954 Internal Revenue Code, the shares held by a trust are considered to be owned by its present or future beneficiaries in proportion to their actuarial interests. Petitioners reasoned that because the language of the attribution rules in § 267(c) was similar to the language of the attribution rules in §§ 421(d)(1)(C) and 544(a)(1), actuarial computations likewise should be used to determine the value of stock owned by the present beneficiary of the trust and the future beneficiaries (those presently unknown persons who would receive the trust property upon the death of the petitioners). In addressing petitioners' argument, the court pointed out that no case interpreting the term "value in section 267(b)" had been brought to its attention.

As to petitioners' contention that their indirect ownership interest must be calculated on an actuarial basis, the court found that the concept of actuarial valuation which petitioners urged was drawn from the context of provisions which arise in an entirely different area of the revenue law and were enacted by Congress for a different purpose than § 267. The court also found that there is no indication in the legislative history of those provisions that a cross-reference of interpretation to § 267 was intended. Thus, the court held that petitioners did not establish that the value of the petitioners' interest in the Atlas stock should be computed by use of actuarial values. In so holding, court concluded that it did not believe that Congress intended that the court should look for parallel terminology in unrelated sections of the Code to ascertain value as used in § 267.

The court found no merit in petitioners' alternative contention that valuation should be made under general valuation principles such as are contained in § 20.2031-1 of the Estate Tax Regulations. In so finding, the court rejected petitioners' position that the fair market value of the petitioners' interest in Atlas stock as defined in those regulations was zero because they could not sell this interest and because of other limitations upon their beneficial interest according to the terms of the trust agreement. The court opined that the regulation did not aid petitioners and had no relevancy to the case.

The court observed that § 267(b)(2) specifically provides that 50 percent in value of the outstanding stock can be owned indirectly and that § 267(c)(1) provides that stock owned by a trust is considered to be owned by the beneficiaries. The court determined that these subsections contemplate valuing the stock interest owned by or for an individual, whether outright or in trust for his benefit, without detracting from the value of the stock because it is indirectly owned rather than directly owned. The court concluded that if § 267 is to apply equally to indirect and to direct ownership, this must be the case. In sustaining the Commissioner, the court concluded that the five shares of Atlas stock

in question are worth the same whether directly or indirectly owned because they are valued without regard to how they are owned.

The court determined that there is nothing in the committee reports or legislative history of § 267 and predecessor sections indicating that the language of § 267 is intended to have a meaning other than that normally implied by the words employed. It follows from this determination that § 267(b) and (c) should be interpreted based on the meaning normally implied by the words employed therein.

As to the plain meaning of the words employed within, § 267(c) provides, in part, that stocks owned, directly or indirectly, by a trust, corporation, or partnership shall be considered as being owned “proportionately” by its beneficiaries, shareholders, or partners. The word “proportionate” means “being in proportion: proportionately adjusted: adequately proportioned”. Webster's Third New International Dictionary (1986). Further, “proportion” means “1 a: the relation of one part to another or to the whole with respect to magnitude, quantity, or degree: relative size: ratio; 2 b: reasonable or desirable estimation or assignment of relative value.” Id. Other common meanings of the word “proportionately” include proper portion of whole, being in correct proportion, relative, properly related in size and degree, and pro rata. Accordingly, to ascertain whether constructive ownership of stock is determined proportionately, it is necessary to determine the following: (1) the whole or total stock ownership, (2) the specific persons that should be taken into account as having a constructive ownership interest in the stock, and (3) each person’s proper portion of ownership of the whole or total relative to others. Ascertaining the proper portion of total stock ownership to assign a person with regard to any Code section used in conjunction with § 267(c) requires consideration of the intent of the provision in conjunction with § 267(c) and the relevant facts. See Hickman.

We believe that to apply the § 267(c) rules in the instant case, it is necessary first to ascertain the total capital or profits interest in Taxpayer owned by each selling trust. Second, it is necessary to determine the specific beneficiaries of each selling trust that should be treated as proportionately owning a capital or profits interest in Taxpayer. Third, it is necessary to determine each beneficiary’s proper ownership portion of the capital or profits interest in Taxpayer that is owned by the respective selling trust in comparison to all other beneficiaries’ proper ownership interest or total capital or profits interest. The factors considered to determine the beneficiaries that should be taken into account as owning a capital or profits interest and to compute a specific beneficiary’s proper ownership portion of the capital or profits interest of Taxpayer owned by a particular trust should be in accordance with the intent of § 707(b). Once a beneficiary’s proportional capital or profits interest in Taxpayer is established under § 267(c)(1), the constructive ownership rules of § 267(c) must be further applied to attribute ownership to other specified persons (e.g., family members) for purposes of determining a person’s direct and indirect ownership of the capital or profits interest of Taxpayer.

Our review of the Form 886-A reveals that Examination has applied two methodologies to ascertain the percentage of ownership of specific persons in the capital or profits interest of Taxpayer. The first methodology involved Examination determining ownership of the selling trusts using equal allocations of ownership to the named and specifically referenced beneficiaries of each trust. Provided the approach is in accordance with the purpose of § 707(b), we believe it is reasonable to apportion interest in Taxpayer equally to each of the named beneficiaries of each respective selling trust because the trustee of each trust has absolute discretion to accumulate or distribute the income and principal of the respective trust any time to one or more of the beneficiaries to the extent that each trustee may terminate any particular trust through such distributions. Further, none of the selling trusts provide for the preservation or protection of the income or principal of the trust for any particular beneficiary. Cf. I.R.S. FSA 199952014 (concluding that for purposes of § 958(a)(2), the trust's income beneficiaries should be treated as proportionately owning stock owned by the trust and the remainder beneficiaries should not be taken into account (1) where a foreign non-grantor trust provides that all of its net income should be distributed to a single named individual or (2) where a foreign non-grantor trust provides for distribution of all of the trust's net income to one or more named individuals in specified proportions).

The second methodology used by Examination involved determining capital or profits interest on the basis of beneficial enjoyment of distributions from the trust over a seven year period. Provided the approach is in accordance with the purpose of § 707(b), we believe the approach is reasonable because the trustees had discretion to distribute funds to the beneficiary or those beneficiaries the trustees considered to be in the best interest to distribute or the beneficiary or beneficiaries needing funds for necessary support. Here, the trustees of the selling trusts determined that, with the exception of one distribution, a single beneficiary (A) was the sole beneficiary qualified to receive distributions annually over the seven year period. Cf. I.R.S. FSA 199952014.

Under §§ 267(c)(2), 267(c)(4), and 707(b)(3), the family attribution rules provide that any capital or profits interest in the partnership shall be considered as owned, directly or indirectly, by or for his family. In the instant case, the purchasers will own any capital or profits interests in Taxpayer owned by their siblings, father, and children. However, § 267(c)(5) prevents a capital or profits interest in a partnership that is constructively owned by a person by reason of § 267(c)(2) from being treated as actually owned by such person for the purpose of again applying § 267(c) to make another person the constructive owner of Taxpayer. Thus, a capital or profits interest in Taxpayer that is constructively owned by any of the purchasers by reason of § 267(c)(2) cannot be used again to reattribute any of the partnership interest to any of the other Purchasers. Here, based on the Examination team's calculations under either methodology, purchasers each own more than 50 percent of the capital or profits interest in Taxpayer.

Ruling 3

In general, a sale transaction is evidence of a closed and completed transaction, provided that the taxpayer can prove the sale actually occurred. The question of when a sale is complete is a factual question. The sale is completed upon the earlier of two events: 1) the transfer and passage of title; or 2) the benefits and burdens of ownership. See Major Realty Corp. v. Commissioner, 749 F.2d 1483 (11th Cir. 1985). The identifiable event must be evident to outside parties and constitute a step that irrevocably cuts ties to the asset. See United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir. 2001).

A potential argument for a disallowance under § 165 is that the loss that results from the transaction between the Selling Trusts and the Purchasing Trusts was not bona fide because there was no genuine economic loss. No loss deduction is allowed when a taxpayer engages in a transaction where the taxpayer retains the same economic position. See Commissioner v. Fink, 483 U.S. 89 (1987); Frantz v. Commissioner, 83 T.C. 162 (1984), aff'd 784 F.2d 119 (2d Cir. 1986). This can be true even if the transaction is itself “bona fide” in that it actually occurred. Lerman v. Commissioner, 939 F.2d 44, 55-56 n. 14 (3d Cir. 1991), affg. Fox v. Commissioner, T.C. Memo 1988-570; Rev. Rul. 2000-12, 2000-1 C.B. 744. Moreover, “Cottage Savings Association v. Commissioner, 499 U.S. 554, (1991), cannot be read for the proposition that, as long as a transaction is bona fide, i.e., actually occurred, it cannot be denied economic substance.” Lerman at 55–56, n. 14.

In Higgins v. Smith, 308 U.S. 473 (1940), the Supreme Court held that a taxpayer did not sustain a loss when he sold securities below cost to his wholly owned corporation because the taxpayer retained control over the stock. In Scully v. Commissioner, 840 F.2d 478 (7th Cir. 1988), the court states that a taxpayer “will not be permitted to transfer assets from one pocket to another and take a loss thereby where he remains at the conclusion of the transfer the real owner of the property, either because of retention of title, command over the property, either directly or through the person who appears as the normal vendee or transferee.” Id., at 485 (citing 7 J. Mertens, Law of Federal Income Taxation § 28.26 (1980)).

In Scully, two trusts were set up for the benefit of Scully’s children and grandchildren (“Scully Buying Trusts”). Scully died in 1961, leaving half of his gross estate, consisting of over 7,000 acres of land, in a marital trust for the benefit of his wife. She died in 1976, and by the terms of her will, divided up most of the 7,000 acres into trusts for the grandchildren, with the Scully children acting as trustees (“Scully Selling Trusts”). Under the terms of the wife’s will, the Scully Selling Trusts were required to pay all the expenses in association with settling her estate; however, the Scully Selling Trusts did not have the funds available to pay these expenses. The Scully Buying Trusts did have the funds to pay these expenses. The Scully children, acting as trustees for the Scully Selling Trusts, arranged for the sale of a portion of the acres to the Scully Buying Trust. The price was determined through the use of an appraisal to fix the value of the real estate for purposes of the estate tax return.

In the year of the sale, the Scully Selling Trusts did not include any gain or loss on the transfer of the acreage. In a subsequent year, after the Service audited the estate return, the Scully Selling Trustees filed a refund claim, stating that the Scully Selling Trusts had sustained a loss on the sale. After dismissing the government's argument for disallowance under § 267, the court held that no deduction was allowed under § 165 because there was no genuine economic loss. The trustees of the trusts were the same, the trustees were related and all of the beneficiaries were the children of the trustees. Further, the trustees admitted that the purpose of the sale was to keep the real estate in the family and to permit the trustees to operate the land in both sets of trusts as a single, integrated economic entity.

In another case involving sales between similar trusts the court applied the same test as Scully, but the facts and circumstances led that court to hold that the loss was allowed. In Widener v. Commissioner, 80 T.C. 304 (1983), two trusts with related grantors, common trustees and a common current income beneficiary sold stock to each other to generate tax losses. The two trusts were created 23 years apart by different grantors, with a common trustee of a bank. One trust was to terminate in 1992 and its assets were to be distributed to its income beneficiary. The other trust was not to terminate until 21 years after the income beneficiary's death and had an investment policy that emphasized growth of the corpus, rather than distributions. The income beneficiary had no power to control any specific investment decisions and she was unaware of the transaction at issue. The court allowed the loss because it concluded that although the selling and the buying trusts had the same income beneficiary, the income beneficiary's interest in the principal of each trust was substantially different following the sale. The court also found that that the income beneficiary did not control the trusts and that the trustees were independent.

Accepting both the form of the transaction and the ownership structures of the Selling Trusts and the Purchasing Trusts in this case, and that a sale actually occurred, the beneficiaries' rights to the transferred interests in E and F are substantially altered by the sale. Although the grantors have a right to reacquire property from the trusts, they must do so for fair value. Since the underlying assets are portfolio type investments this element of control is not significant enough to deny the loss. The sale greatly increases the beneficial interest of A's grandchildren in E and F, and if we disregard the Purchasing Trusts as separate entities from their owners and treat B, C and D as acquiring the interests in E and F directly, the sale still eliminates A's beneficial interest in E and F. This would be true even if B, C and D exercised their rights to reacquire the interests in E and F from the Purchasing Trusts. Therefore, the "one pocket to the other" rationale fails, and the loss would be treated as bona fide.²

² In the revenue agent's memorandum, Examination alleges that the sale was mispriced, and points out that the transaction was not at arm's length. If this is the case, the transaction was part sale and part gift with the difference between the fair market value and the amount received being a gift to A's children or grandchildren.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

With respect to Ruling 1, it should be noted that there have been a very limited set of circumstances after the publication of Rev. Rul. 85-13 where the Service or the

courts have treated a grantor trust and its owner as separate entities for a federal income tax purpose:

(1) Rothstein itself has never been overturned, and theoretically is still good law in the Second Circuit. We have found only one case which, in dicta, follows the reasoning in Rothstein. In Zand v. Comm’r, T.C. Memo 1996-19, the Tax Court found that a grantor was not the owner of a trust under § 675(3), relating to grantor borrowings from the trust, because the loan met the exceptions provided in § 675(3) for borrowings with adequate interest and security made by an independent trustee. The Court continued, however, that even had the grantor been properly treated as the owner, he still would have been able to deduct interest paid to the trust because the grantor trust provisions only relate to income attribution.

(2) Rev. Rul. 85-13 never explicitly revoked or modified Rev. Rul. 74-243, 1974-1 C.B. 106. Rev. Rul. 85-13 cites numerous cases and rulings for its conclusion, but also mentions Rev. Rul. 74-243 as one counter-example. In Rev. Rul. 74-243, a corporate executive accepted a government appointment and transferred property, including a qualified stock option, to a “blind trust” which would have been a grantor trust under § 677, although the ruling does not explicitly describe it as a grantor trust. The ruling concludes that the transfer of the option to the trust was a taxable disposition under § 425. Rev. Rul. 74-243 has not been applied or cited approvingly by the Service or a court after 1985, although it arguably still technically reflects the Service’s position under the narrow facts of the ruling. Moreover, at least two PLRs (9124019, 9309027) (both issued by CC:TEGE apparently without coordinating with CC:PSI) have allowed similar transfers to grantor trusts without triggering a taxable disposition.

(3) Textron v. Comm’r, 117 T.C. 67 (2001) was arguably inconsistent with Rev. Rul. 85-13. In Textron, a domestic corporation owned substantially all the stock of a foreign corporation, which it was ordered (initially by the Federal Trade Commission, and later confirmed by a federal district court injunction) to transfer to a voting trust with a court-appointed trustee. It was uncontested that the voting trust was a grantor trust to Textron under § 677. The issue before the Tax Court was whether Textron was taxable on the foreign corporation’s subpart F income during the existence of the voting trust; the Court found that the trust, not Textron, was the shareholder for purposes of §§ 951(a) and 958(a), but then ruled in favor of the government on the alternative ground that the trust was taxable as the subsidiary’s U.S. shareholder, with the subpart F income then flowing through to Textron. The decision was criticized for its inconsistency with Rev. Rul. 85-13 and other grantor trust authority in Stevens, Matthew A., “A Grantor Trust Visits Subpart F: Ruminations on Textron v. Commissioner and other Anomalies”, 21 Va. Tax Rev. 507 (2002).

(4) PLRs 20117042 and 201129045 appear to conflict with Rev. Rul. 85-13. PLRs 20117042 and 201129045 were issued by IRS Employee Plans, and state that an individual retirement account (IRA) cannot be transferred to a grantor trust of the IRA owner. The conflict between these rulings and Rev. Rul. 85-13 was noted in Beers, Deborah M., "IRS Issues Two Seemingly Contradictory Rulings on Effects of Transfer of IRA to Special Needs 'Grantor' Trust", 36 Tax Mgmt. Est. & Tr. J 230 (2011) and Jones, Michael J., "The Economy and other Retirement Mysteries", Trusts & Estates, January 2012, at 35. Both articles mention prior PLRs issued by the same office appearing to accept that the owner of a grantor trust is the owner of its assets, which may include an IRA. See PLRs 200620025, 200826008, and 201116005.

With respect to Ruling 2, the court in Hickman provided no interpretation of the term "value" or any other terms used in § 267(b) and (c). In addition, there is no other court case or Service guidance addressing the issue of valuation of a beneficiary's interest in a trust under § 267(c) to determine a beneficiary's ownership interest in a corporation or a partnership. In the absence of specific guidance, a court could decide to utilize a different methodology than Examination used to determine each beneficiary's capital and profits interest in Taxpayer. For example, a court could conclude that the facts and circumstances methodology used in PLR 9024076, which the Examination team describes but does not apply in the Form 886-A, is a reasonable valuation method when determining a beneficiary's proportionate interest in a partnership.

Further, in Hickman no one had a beneficial interest in the trust during the petitioners' lifetime except the petitioners. Thus, the only remaining interest that could have possibly been valued was the petitioners' power to appoint corpus. The instant case presents a situation where there are unknown (unborn) remaindermen under the terms of the trust. A court may determine that §§ 707(b) and 267(c) require a portion of the partnership interest be apportioned to these unknown (unborn) remaindermen because these remaindermen are also beneficiaries of the trust under the trust agreement.

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Please call _____ if you have any further questions.

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