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

200252096

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

TI80:B3

UIL Numbers: 512.09-01
664.00-00

Date:
SEP 26 2002

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legends

Trust =
Fund =
x =

Dear Sir or Madam:

This letter responds to Trust's request dated March 1, 2002, for a ruling regarding the proposed transaction described below.

Trust is a charitable remainder unitrust described in section 664(d) of the Internal Revenue Code ("Code"). Trust intends to form a wholly owned for profit corporation ("Corporation"), subject to income tax under section 11 of the Code. Trust will contribute approximately x to the Corporation. Trust will not incur any debt to create or fund the Corporation. Once formed, the Corporation will follow all the corporate formalities required under the appropriate state law and will keep its corporate assets separate from the assets of Trust.

Trust anticipates that the Corporation will use the funds contributed by Trust to purchase a membership interest in the Fund, a limited liability company, which is engaged primarily in the business of leasing equipment. The Fund anticipates using debt financing to partially fund its acquisition of equipment.

Trust represents that it has several business purposes for establishing a wholly owned corporation to make investments. First, use of a holding corporation will provide Trust flexibility in disposing of investments. The Fund's operating agreement, which was provided in the ruling request, includes a number of restrictions on the ability of any member to transfer or dispose of membership interests in the Fund. Specifically, the operating agreement provides that the Fund's manager may block any transfer of shares if a member assigns less than five shares, or if the assignment would result in a member retaining less than five shares, or if the assignee is not a suitable investor under state or federal securities laws, or if the assignee is not a United

States citizen and the transfer would cause an impermissible percentage of shares to be owned by noncitizens.

The operating agreement also allows the manager to block a transfer if the Fund's tax counsel determines that such transfer would terminate the Fund's taxable year or its status as a partnership for federal tax purposes. Even if an assignment is permitted under the operating agreement, there may be delay and uncertainty before such a transfer can take effect; the operating agreement does not specify how long the manager has to void an attempted transfer if it determines the transfer violates the operating agreement. Trust represents that a member cannot necessarily determine whether a desired transfer will be possible, since some of the restrictions depend on how many other shares have changed hands during the year and this information might not be available when a member is negotiating a sale.

If Trust owned shares in the Fund, Trust represents that it may not be able to dispose of its shares when it desires to do so. Trust represents there is uncertainty about whether an assignment will be possible thereby increasing the expense and difficulty of disposing of shares. Trust represents that by investing in the Fund through a holding company instead, Trust will have more flexibility to dispose of its investment when it desires to do so, because Trust can sell all of its stock or a portion of its stock in the Corporation at any time, and it can negotiate such a sale without the need for approval by the Fund manager.

Trust represents the Corporation will provide it with additional limited liability protection. The Fund intends to lease aircraft and marine vessels for use outside of the United States, creating potential exposure to international tort claims. Since it is not now known where the Fund might lease equipment, Trust represents that it would be prohibitively expensive to research the legal regimes of all possible countries where the Fund might face legal action. Because the Corporation rather than Trust will be a member in the Fund, Trust's other assets will be insulated from such potential exposure to international tort claims.

Trust represents that the Corporation will provide additional protection against United States claims. The applicable state law provides that a member is not liable for debts of a limited liability company unless the member agrees to be personally obligated on the debt. However, limited liability members may be liable for debts of the limited liability company under a piercing-the-veil theory. Because the Corporation rather than Trust will be a member of the Fund, a judgement creditor of the Fund would have to pierce the corporate veil not once but twice to reach the other assets of Trust, providing additional limited liability protection.

The Corporation may also make and manage additional investments, funded either through retained earnings or additional capital contributions. The Corporation will manage these investments, relieving Trust of this duty, and will shield Trust from any possible involvement in an unrelated business that could expose Trust assets to potential liability or generate unrelated business taxable income.

Trust will hold its shares of Corporation stock as investment property and will not be a trader or dealer of securities.

Trust has requested the following rulings:

1. Whether the Corporation's allocable share of income and gains under section 704 of the Code from the Fund will constitute unrelated business taxable income to Trust within the meaning of section 512.

2. Whether distributions of cash or property from the Fund to the Corporation will constitute unrelated business taxable income to Trust within the meaning of section 512 of the Code.

3. Whether distributions from the Corporation to Trust will constitute unrelated business taxable income to Trust within the meaning of section 512 of the Code.

4. Whether any gain realized by Trust on the ultimate sale or disposition of shares of Corporation stock will constitute unrelated business taxable income to Trust within the meaning of section 512 of the Code.

Law

Section 664(c) of the Code provides that a qualifying charitable remainder trust is exempt from income taxes for any taxable year unless the trust has unrelated business taxable income for such year. If the trust has unrelated business taxable income for any taxable year, then the trust is not exempt from taxes, and is subject to taxation under the normal rules of Subchapter 1.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" ("UBTI") as gross income derived by an organization from an unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(1) of the Code excludes all dividends from the computation of UBTI.

Section 512(b)(3) of the Code provides that rents attributable primarily to leases of personal property are not excluded from the definition of UBTI.

Section 512(b)(4) of the Code provides that notwithstanding the general exclusion of dividends from UBTI, dividends and other passive investment income derived from debt-financed property are treated as gross income from an unrelated trade or business in an amount determined under section 514(a)(1). Deductions from such debt-financed property are allowed in an amount ascertained under section 514(a)(2).

Section 512(b)(5) of the Code provides that gains from the sale or disposition of property (other than inventory or property held primarily for sale to customers) are excluded from the computation of UBTI.

Section 512(b)(13) of the Code provides special rules for certain amounts of income an exempt organization receives from a controlled entity.

Section 512(b)(13)(A) of the Code provides that notwithstanding sections 512(b)(1), (2) and (3) of the Code an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity), shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

Section 512(b)(13)(C) of the Code provides that the term "specified payment" means any interest, annuity, royalty, or rent.

Section 512(c) of the Code provides that if a trade or business is regularly carried on by a partnership of which an organization is a member, and if the partnership business is unrelated to the exempt purpose of the organization, the organization shall include its allocable share (whether or not distributed) of partnership gross income.

Section 514(a) of the Code provides that in calculating UBTI, there shall be included a percentage of gross income from debt-financed property and a percentage of deductions directly connected with debt-financed property or the income thereof. The percentage of income and deductions included in the calculation of UBTI is proportional to the average amount of acquisition indebtedness with respect to the property.

Section 514(b) of the Code defines "debt-financed property" to mean any property held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

Section 514(c) of the Code defines "acquisition indebtedness" with respect to property as unpaid indebtedness that is incurred to acquire or improve such property; unpaid indebtedness incurred before the acquisition or improvement of the property if the debt would

not have been incurred but for such acquisition or improvement of the property; or unpaid indebtedness incurred after the acquisition or improvement of the property if such debt would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Section 704 of the Code sets forth rules regarding determination of tax liability for partners and partnerships, specifically the determination of a partner's distributive share of income, gain, loss, deduction, or credit.

For federal income tax purposes, a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is formed are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Comm'r., 319 U.S. 436, 438 (1943); Britt v. U.S., 431 F.2d 227, 234 (5th Cir. 1970). Where an organization is organized with the bona fide intention that it will have some real and substantive business function, its existence may not generally be disregarded for tax purposes. Subsidiary corporations are separate entities from a taxable parent, if the organizational purpose is a business purpose, so that subsidiaries cannot avoid being separately taxed. This rationale also applies to the parent.

Under sections 512(c), 512(b)(4), and 514 of the Code, income from the Fund would be UBTI to Trust if received directly by Trust because it is debt-financed income. However, here the income will arrive to Trust indirectly through the Corporation, which will pay dividends to Trust. Dividend income is not taxable under section 512(b)(1), or subject to the "controlled organization" rules of section 512(b)(13). Further, Trust has not itself incurred debt in financing its interest in the Corporation, and thus such dividend income is not debt-financed income described in section 514. Since the Corporation stock owned by Trust will not be debt-financed property, dividends paid on the stock will be exempt from UBTI under section 512(b)(1).

The shares of Corporation stock owned by Trust will not be debt financed property, and the shares will be investment property rather than property held as inventory or for the sale to customers. Therefore, any gain on the sale or disposition of the shares will be excluded from UBTI under section 512(b)(5) of the Code.

Accordingly, based on your representations that Corporation will have real and substantive business purposes, we rule as follows:

1. The Corporation's allocable share of income and gains under section 704 of the Code from the Fund will not constitute unrelated business taxable income to Trust within the meaning of section 512.

2. The distributions of cash or property from the Fund to the Corporation will not constitute unrelated business taxable income to Trust within the meaning of section 512 of the Code.

3. The distributions from the Corporation to Trust will not constitute unrelated business taxable income to Trust within the meaning of section 512 of the Code.

4. The gain realized by Trust on the ultimate sale or disposition of shares of Corporation stock will not constitute unrelated business taxable income to Trust within the meaning of section 512 of the Code.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited by others as precedent.

This ruling is limited to the applicability of section 512 of the Code to the issues presented. This ruling does not purport to address any issues under section 664 of the Code and Chapter 42, including sections 4941 and 4945. This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3