LTR 9535026, May 31, 1995
Symbol: CC:DOM:P&SI:4-TR-31-2730-94,
Uniform Issue List No.: 2512.00-00
[Code Sec. 2512]

Valuation of gift.

This is in response to your letter dated April 20, 1995, and prior correspondence in which you requested rulings under §§ 671, 2036(a), 2512, 2701, and 2702 of the Internal Revenue Code.

In 1992, A established an irrevocable trust ("Trust") for the benefit of his three children. Trust provided for a separate share for the benefit of each of three children, B, C, and D. Under the terms of the Trust, the beneficiaries of each separate share include the named child, his or her spouse, or unmarried surviving spouse, descendants, spouses and unmarried surviving spouses of descendants. A's wife and a bank are named trustees. The Trust establishes a "Protector", to review the performance of the trustees. A and his children can not serve as trustees or Protector.

A transferred assets to the three separate shares of Trust. Each child has also made transfers to his or her respective share. Pursuant to authority conferred upon the Trustees under Item Six of Trust, the trustees divided each share into two portions, one to hold assets transferred by A and one to hold assets transferred by the respective child. With respect to the second portion, the trustees have created a separate trust. Thus, each separate trust estate, consists solely of assets contributed by the respective child.

Each child proposes to sell Stock to his or her respective separate trust (RST). In return for the stock, each child will receive a promissory note from the RST. The trustees of the RST will pay interest for 20 years to each child. A balloon payment of principal will be paid at the end of 20 years. The notes will bear sufficient interest such that the loan will not be characterized as a below market loan under § 7872. The notes provide that payments of interest and principal may be paid in cash or property, but in no event shall any payments be made by promissory notes. The note issued by the RST will be secured by the stock transferred to the RST.

The trusts provide that the Trustees shall distribute to such of the beneficiaries of any such separate share thereof, as the Trustees shall designate, living on any distribution date, all or such amount or amounts of the net income and principal of such separate share as the Trustees shall from time to time determine to be appropriate for any reason whatsoever.

You have requested the following rulings on behalf of B, C, and D.

1. The RST will be considered a grantor trust under § § 675 and 677. Accordingly, the sale of stock to the RST by the child will not be recognized for income tax purposes by virtue of § 671. Therefore, all items of RST income, deduction and credit will be included in the child's individual income tax returns. No capital gain arising from the sale will be recognized by the child. The trust will assume the child's basis in the Stock. The RST will not be entitled to a deduction for interest paid to the child and the child will not be required to include interest income from the notes in taxable income.

2. The fair market value of the notes issued in consideration for the purchase of stock by each RST will be for purposes of Chapter 12 of the Internal Revenue Code, the face amount of the notes. The sale will not be considered a gift to the extent the fair market value of stock transferred to the RST in exchange for the note does not exceed the face amount of the note.

3. The note issued by the RST to the child will not constitute applicable retained interests under § 2701.

4. Section 2702 is not applicable to the proposed transaction.

Ruling Request 1

Section 671 of the Code provides that where the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under Chapter 1 of the Code in computing taxable income or credits against the tax of an individual.

Sections 673 through 677 of the Code specify the circumstances under which a grantor is treated as the owner of a portion of a trust.

Section 677(a) of the Code provides in part that a grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor

or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse.

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that, if a grantor is treated as the owner of an entire trust, the grantor is the owner of the trust's assets for federal income tax purposes. Therefore, a transfer of assets to the trust by the grantor who owns the entire trust is not recognized as a sale for federal income tax purposes.

In the present case, each child will sell stock solely to his or her wholly owned trust (RST). Under section 677(a) of the Code, each child is the owner of the RST of which he or she is the grantor. Each child will be considered the owner of his or her respective RST for purposes of section 671 and shall include in computing his or her taxable income those items of income, deductions, and credits against tax which are attributable to his or her RST.

In accordance with the holding set forth in Rev. Rul. 85-13, we conclude that none of the children nor their RST will recognize any gain or loss as a result of the transfers of stock to their RST. Each RST will assume its respective child's basis in the stock transferred. Each RST will not be entitled to a deduction for interest paid to the respective child, and each child will not include interest income from the notes in his or her taxable income.

Ruling Request 2

Section 2501(a)(1) provides for the imposition of a gift tax on the transfer of property by gift. Section 2511(a), provides that the gift tax applies to a transfer, by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 25.2512-5A(d)(1)(i)(A) provides that, where a donor transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest.

Section 1274(d)(1) provides that the applicable federal rate for a debt instrument with a term of over nine years is the federal long-term rate.

Section 7520 provides that the valuation of annuities, interests for life, terms of years, and remainder and reversionary interests is to be determined under tables published by the Internal Revenue Service and based on a discount rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the applicable federal mid-term rate in effect under § 1274(d)(1) for the month in which the valuation date falls.

Section 7872 is applicable to term loans made after June 6, 1984, and to demand loans outstanding after that date. The section applies to "below-market" loans. A "below-market" loan, in the case of a term loan (as defined in § 7872(f)(6)), is a loan where the amount loaned exceeds the present value of all payments due under the loan. Under § 7872(d)(2), a "gift loan" that is a below-market loan is recharacterized for gift tax purpose as a transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the amount loaned over the present value of all payments required to be made under the terms of the loan. A "gift loan" is a loan where the foregone interest is in the nature of a gift. Section 7872(f)(3).

Section 7872(f)(1) provides that the present value of any payment is determined by using a discount rate equal to the applicable federal rate as of the date of the loan. In the case of term loans, the applicable federal rate is the applicable federal rate in effect under § 1274(d), compounded semiannually, as of the date the loan is made. Section 7872(f)(2)(A). Following the amendment of § 1274(d) by § 101(b)(1) of the 1985 Imputed Interest Simplification Act, Pub. L. No. 99-121, 1985-2 C.B. 367, the Commissioner prescribes equivalent rates based on compounding periods other then semiannual compounding (for example, annual compounding, quarterly compounding, and monthly compounding), to facilitate application of § 7872 to loans other than those involving semiannual payments or compounding. See, Rev. Rul. 86-17, 1986-1 C.B. 377. Section 7872 generally does not apply to any loan to which section 483 or 1274 applies. Section 7872(f)(8).

In Frazee v. Commissioner, 98 T.C. 554 (1992), [CCH Dec. 48,195], the Tax Court addressed the issue of whether, for gift tax purposes, the fair market value of a promissory note issued by children to their parents in exchange for real property must be determined by use of a discount rate prescribed under § 7872, or the safe harbor rate provided under § 483(e). The court also considered the application of the rates prescribed under § 1274. The court concluded that § 7872 applied in determining the gift tax treatment of below-market loans regardless of

whether the transaction involved a sale of property or a cash loan. The court reaffirmed its earlier position in Krabbenhoft v. Commissioner, 94 T.C. 887 (1990) [CCH Dec. 46,659], aff'd 939 F.2d 529 (8th Cir. 1991) [91-2 USTC ¶ 60,080], that § 1483 does not apply for gift tax purposes. In concluding that § 1274 was not applicable in valuing the note for gift tax purposes, the court stated that § 1274 characterizes installment payments as principal or interest and, where stated interest is inadequate, it imputes interest. On the other hand, the court noted § 7872 was enacted specifically to address the gift tax treatment of below-market loans. Thus, the court concluded that the application of § 7872 is not limited to loans of cash. Rather, the term "loan" under § 7872 is broadly interpreted to include any extension of credit.

As noted above, for term loans, in determining whether a loan is a below-market loan, § 7872(f)(1) and (2) requires use of a discount rate equal to the applicable federal rate in effect under § 1274(d) on the date the loan was executed. Section 1274(d)(1)(A) uses the applicable federal long-term rate for debt instruments with a term of over nine years. Thus, in general, under § 7872, a promissory note for a term longer than nine years is not treated as a below-market loan if the interest rate on the note is equal to or higher than the applicable federal long-term rate, compounded semiannually.

In the present case, the stated interest rate on the notes will equal the rate prescribed by § 7872. Thus, we conclude that, if the fair market value of the stock transferred to the RST equals the principal amount of the note, the sale of stock to the RST will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the RST's ability to pay the notes is not otherwise in doubt.

Ruling Requests 3 & 4

Section 2701(a) provides that, solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift (and the value of the transfer), the value of any right -- (A) that is described in § 2701(b)(1)(A) or (B), and (B) that is with respect to any "applicable retained interest" that is held by the transferor or an applicable family member immediately after the transfer, shall be determined under § 2701(a)(3).

Section 2701(b)(1) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is -- (A) a distribution right, but only if, immediately before the transfer described in § 2701(a)(1), the transferor and applicable family members hold control of the entity or (B) a liquidation, put, call, or conversion right.

Section 25.2701-2(b)(1) of the Gift Tax Regulations provides that an applicable retained interest is an equity interest in a corporation or partnership that is either an extraordinary payment right or a distribution right.

Section 25.2701-2(b)(3) provides that a distribution right is the right to receive distributions with respect to an equity interest.

Section 2702(a) provides that, for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a family member of the transferor's family is a gift (and the value of the transfer), the value of any interest in the trust retained by the transferor or any applicable family member (as defined in § 2702(e)(2)) shall be determined as provided in § 2702(a)(2).

Under § 2702(c)(1), the transfer of an interest in property with respect to which there is 1 or more "term interests" shall be treated as a transfer of an interest in trust.

Section 2702(c)(3) provides that the term "term interest" means -- (A) a life interest in property or (B) an interest in property for a term of years. See also § 25.2702-4(a).

Section 25.2702-2(d)(3) provides that the term "retained" means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

In this case, B, C, and D will sell Stock to their RST, and immediately afterwards, will hold debt. A debt instrument is not an applicable retained interest that is subject to the provisions of § 2701. Therefore, we conclude that § 2701 does not apply to these transactions.

In this case, B, C, and D will sell Stock to their RST. In exchange, they will receive debt. Under the facts presented here, the debt instrument involved is not a "term interest" within the meaning of § 2702(c)(3) and the applicable regulations. Therefore we conclude that the valuation rules provided in § 2702 do not apply to these transactions.

The above rulings (2-4) will be considered void if the promissory notes are subsequently determined to be equity or not debt. We express no opinion about whether the notes are debt or equity because that determination is primarily one of fact (section 4.02(1) of Rev. Proc. 95-3, 1995-1 I.R.B. 85 (94). Nor do we express any opinion as to the collectiblity of the notes.

Except as we have specifically ruled herein, we express no opinion about the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. Specifically, we are expressing no opinion regarding the application of §§ 2511 or 2702 to any other transfers to the RSTs. See, e.g. Rev. Rul. 77-378, 1977-2 C.B. 348. Additionally, we are expressing no opinion regarding the application of § 2036 to the transaction.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Sincerely, Assistant Chief Counsel (Pass-throughs and Special Industries), George Masnik, Chief, Branch 4

LTR 9535027, June 1, 1995

Symbol: CC:DOM:FI&P:2-TR-31-49-95

Uniform Issue List No.: 0856.04-00

[Code Sec. 856]

Definition of real estate investment trust; Rents from real property;

This is in reply to your December 30, 1994 letters requesting the Internal Revenue Service to issue a ruling that the described Coupon Program will not cause the amounts Trust receives through Partnership from its factory outlet centers to be other than "rents from real property" under Section 856(d) of the Internal Revenue Code.

FACTS

Trust is a corporation that intends to elect as of its taxable year ending on December 31, 1994 to be taxed as a real estate investment trust (REIT) under Sections 856 through 860 of the Internal Revenue Code (the Code). Trust's principal asset is an approximately a% capital interest in Partnership, a Delaware limited partnership. Trust is Partnership's sole general partner. Trust's board of directors consists of seven directors, three of whom are either affiliated with or are limited partners in Partnership and four of whom are independent directors.

Partnership's principal assets consist of partnership interests in partnerships that own factory outlet center shopping malls (factory outlet centers). Partnership owns b% interests in partnerships owning c factory outlet centers, a d% interest in a partnership that owns f factory outlet centers, and a e% interest in a partnership that owns f factory outlet centers. Additionally, Partnership owns interests in partnerships that own land, a retail/office facility and small community shopping centers.

Partnership intends to form Service Corporation which will issue two classes of stock--non-voting and voting common. Partnership will own 100% of the non-voting stock. The voting stock, representing approximately 2% of the economic interest in Service Corporation, will be owned by three individuals who are officers or directors of Trust or are both. There will be no restrictions on the disposition of the voting stock.

Service Corporation intends to sell coupon booklets or packets to the public (Coupon Program). The Coupon Program will be implemented only for factory outlet centers and not for the community shopping centers or the retail/office facility. The Coupon Program is scheduled to commence around Date.

Each coupon booklet will contain coupons usable at stores located only in a single factory outlet center. The coupons will entitle holders to discounts on purchases at participating stores in the factory outlet center. Also under consideration is the inclusion of coupons for regional attractions unaffiliated with Trust and the factory outlet centers, such as nearby waterparks, hotels and amusement parks. Each booklet will contain a minimum advertised savings of $g. There will be no prohibitions relating to the transfer of coupons by a purchaser of a booklet.

Employees of Service Corporation will sell the coupon booklets at the applicable factory outlet center and in the general geographic area of the factory outlet center. Booklets will be priced at approximately $h.

Service Corporation will obtain tenant participants in the Coupon Program by contacting each tenant in a given factory outlet center. Tenant participation is strictly voluntary. No fee is charged for participating. Participating tenants are free to withdraw from the program and non-participating tenants can elect to participate later at no cost. Service Corporation is under no obligation to institute the Coupon Program at any particular factory outlet center and can cancel a Coupon Program being conducted at any factory outlet center at any time. There is no legal docu-