Letter Ruling Alert

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CRUT Avoids UBTI by Investing Through a Foreign Corporation

Introduction

In a series of identical letter rulings, the Service ruled that a charitable remainder unitrust (CRUT) will not realize unrelated business taxable income (UBTI) from its investment in a limited partnership. The limited partnership plans to form a foreign corporation that will make investments that would be UBTI under the debt-financed property rules if made directly by the CRUT or directly by the limited partnership. By making the investment through a foreign corporation, the UBTI is converted into dividend income and is excluded from UBTI. (LTR 200251016 is reprinted at p. 213. The other two letter rulings are LTR 200251017 and LTR 200251018.)

Background

A CRUT is a trust that generally is required to pay a fixed percentage of the fair market value of the trust's assets to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. Charitable remainder trusts that meet certain statutory requirements will qualify for federal income tax exemption under section 664. However, charitable remainder trusts lose their income tax exemption for any year in which they have UBTI, as defined by section 512.

Investment income is generally excluded from UBTI. Specifically, under sections 512(b)(1) through (3), dividends, interest, rent from real property, royalties, and annuities are excluded from UBTI. There are two exceptions to this rule that are relevant to these private letter rulings. First, if an exempt organization incurs debt to make the investment, otherwise excludable investment income is included in UBTI under the debt-financed property rules, based on the proportion of debt to the basis of the property. See sections 512(b)(4) and 514. Second, if the exempt organization receives the investment income from a controlled subsidiary it may be taxable under section 512(b)(13). There is an exception to the exception for dividends — i.e., dividends paid by a controlled subsidiary to an exempt organization are not taxable under section 512(b)(13).

If an exempt organization is a member of a partnership and the partnership engages in an activity that would be an unrelated trade or business if engaged in by the exempt organization, the exempt organization must include in UBTI its share of the partnership's income from the unrelated trade or business activity. See section 512(c).

Facts

In each of the letter rulings, the CRUT is a limited partner in a limited partnership (the "Limited Partnership") that plans to organize a foreign corporation (the "Foreign Corporation"). Initially and for some time thereafter, the Limited Partnership will own all the outstanding shares of stock in the Foreign Corporation.

The Foreign Corporation in turn will acquire a limited partnership interest in each of several limited partnerships organized in various U.S. and non-U.S. jurisdictions (and classified as partnerships for U.S. federal income tax purposes) as well as in several non-U.S. entities classified as associations taxable as corporations for U.S. tax purposes (each, a "Fund" and, collectively, the "Funds"). The Foreign Corporation's capital contribution to the Funds will be made using capital contributed by the Limited Partnership and funds borrowed from third parties.

The CRUT's investment in the Funds through its interest in the Limited Partnership is illustrated by the diagram on the next page.

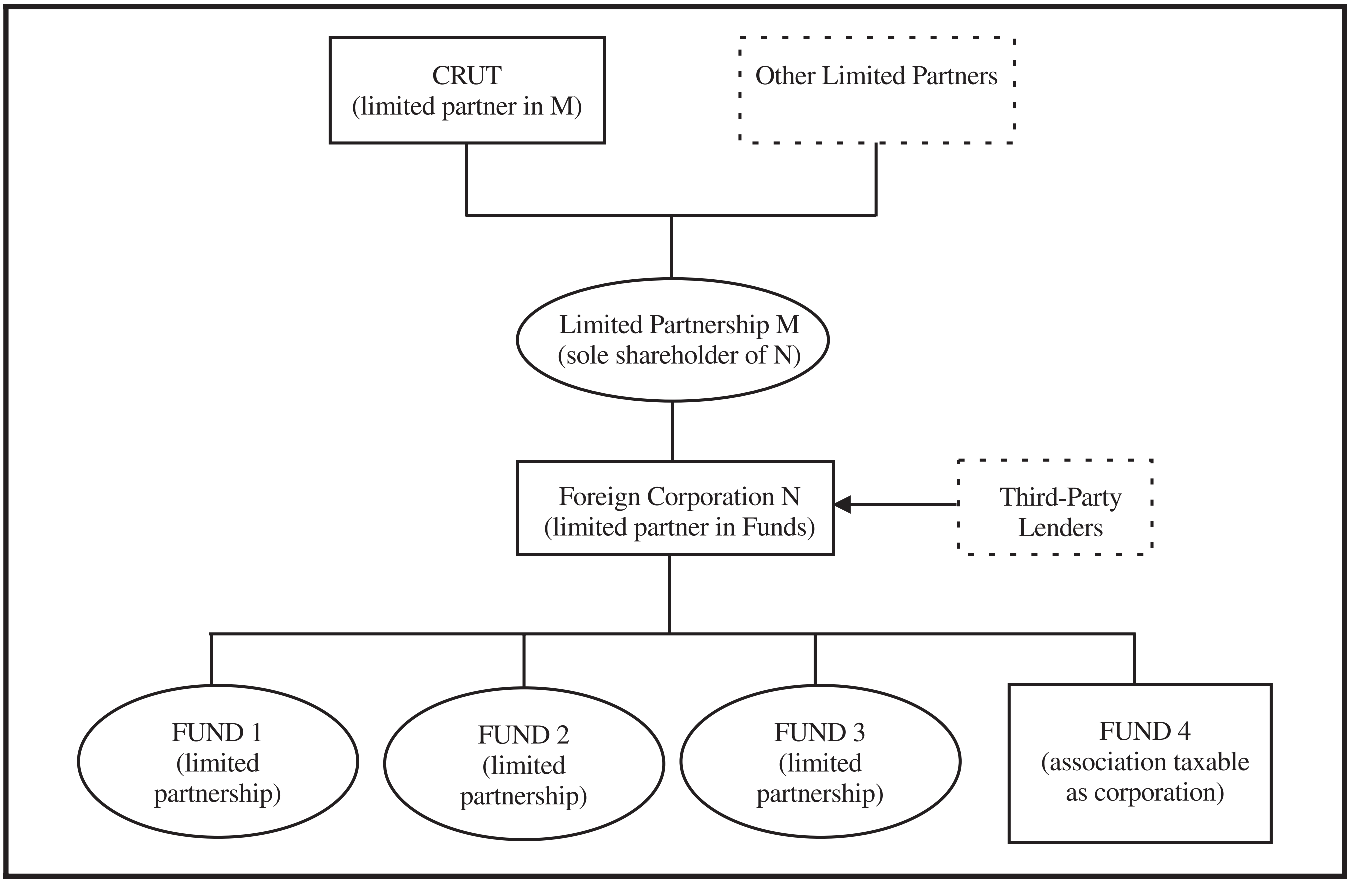
The Funds will acquire and manage diverse portfolios of stocks and other securities. Some of the Funds may borrow amounts in excess of the capital contributed by its partners to acquire investments. Some of the Funds will permit annual or quarterly withdrawals, while some of the Funds will require a limited partner to maintain its capital invested in the Fund for a predetermined period of years. The Foreign Corporation generally would not be able to transfer or otherwise assign its interest in each of the Funds without the prior written consent of the general partner of the Fund, which may be withheld in its sole discretion.

In addition to investing in the Funds through the Foreign Corporation, the Limited Partnership also would continue to make investments in other limited partnerships and investment vehicles.

The CRUT represented to the Service that the Foreign Corporation will be operated as an entity separate from the Limited Partnership, that it will observe corporate formalities, and that it will not be an agent of the Limited Partnership — i.e., it will invest for its own account as a principal.

The CRUT also represented that it had the following business reasons for investing through a Foreign Corporation formed by the Limited Partnership:

1. The Foreign Corporation will provide the Limited Partnership with more flexibility in disposing of indirect



interests in the Funds. While the interests in each of the Funds could not be transferred or otherwise assigned without the prior written consent of the general partner of the Fund, which may be withheld in its sole discretion, investing in the Fund through the Foreign Corporation will give the Limited Partnership the option of disposing of the Foreign Corporation's stock instead, which requires no prior written consent.

2. Investing in the Funds through the Foreign Corporation will further insulate the Limited Partnership and the CRUT against liabilities asserted against partners of the Funds.

3. The Foreign Corporation will be in a position to manage the Limited Partnership's various investments more efficiently.

4. The formation of the Foreign Corporation will allow the Limited Partnership to avoid generating UBTI.

The CRUT requested a ruling that it would not realize UBTI as a result of being a partner in the Limited Partnership and receiving items of income, gain, loss, deduction and credit, and distributions based on the Limited Partnership's owning all or a majority of the stock in the Foreign Corporation.

IRS Analysis and Ruling

In analyzing the issue, the Service referred back to its rulings on a similar issue that arose in the 1980s and 1990s when exempt organizations formed offshore insurance companies and took the position that dividends paid by the companies to them were excludable as dividends under section 512(b)(2). In several rulings, the Service agreed with the exempt organizations' position and ruled that dividends paid by the insurance companies were excludable under section 512(b)(2). LTRs 9407007 (Nov. 12, 1993), 9027051 (Apr. 13, 1990), 9024086 (March 22, 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), 8819034 (Feb. 10, 1988). In one ruling, it used a look-through approach and concluded that, because operating an insurance business was an unrelated trade or business, the exempt shareholders in the insurance company realized UBTI. LTR 9043039 (July 30, 1990).

In 1996, Congress resolved this issue by adding section 512(b)(17) to the code. In general, that section provides that exempt organizations that conduct insurance activities through a foreign corporation will be subject to U.S. tax with respect to such activities. Specifically, section 512(b)(17) provides that any amount included in gross income under the Controlled Foreign Corporation (CFC) rules of subpart F will be treated as unrelated business taxable income to the extent that the amount is attributable to insurance income as defined under section 953.

In the legislative history to section 512(b)(17), Congress expressed approval of the rulings in which the Service concluded that dividends paid by a CFC were excludable under section 512(b)(2) and criticized the look-through approach that the Service took in LTR 9043039. Citing this legislative history, the Service concluded that Congress intended that non-insurance income paid by CFCs to exempt organizations in the form of dividends be excludable under section 512(b)(2). Because the Foreign Corporation would not have insurance income (as defined for purposes of section 512(b)(17)), the Service concluded that dividends paid by the Foreign Corporation to the CRUT would not be UBTI under section 512(b)(17).

The Service noted that under sections 512(c), 514, and 512(b)(4), income from the Foreign Corporation's investments in the Funds would be UBTI to the Limited Partnership if received directly by the Limited Partnership because it is debt-financed income (that is, the Foreign Corporation incurred debt in financing its interest in the Funds). However, because the income in this case would arrive at the Limited Partnership indirectly through the Foreign Corporation in the form of dividends, and because the Limited Partnership itself would not incur debt in financing its interest in the Foreign Corporation, the dividend income paid to the Limited Partnership by the Foreign Corporation would not be debt-financed income under section 514 and therefore would not be treated as UBTI. Further, although the Limited Partnership would own all or a majority of the Foreign Corporation, dividends are not includable in UBTI under the controlled subsidiary rule of section 512(b)(13). These rulings were based on the CRUT's representations that the Limited Partnership had real and substantive business purposes for establishing the Foreign Corporation.

Comment

These three rulings are not the Service's first ruling on this issue. In addition to the rulings described above that dealt with offshore insurance companies, the Service issued a ruling on a similar investment structure in 1999. In LTR 199952086 (Sept. 30, 1999), a CRUT proposed to create and fund a foreign corporation that would, in turn, invest in a U.S. Partnership (the Fund). The Fund would use debt financing to partially fund its acquisition of investment assets. Using language that is essentially identical to the current rulings, the Service held in the 1999 ruling that income paid by the Foreign Corporation to the CRUT would not be UBTI. Although the structure in the current rulings includes a Limited Partnership between the CRUT and the Foreign Corporation, and the structure in the 1999 ruling did not, that difference did not have any impact on the tax result. That is because it is the Foreign Corporation that plays the critical role of converting income that would be includable in UBTI as debt-financed income to dividend income. (For LTR 199952086, see *The Exempt Organization Tax Review*, February 2000, p. 274; *Doc 2000-486 (5 original pages)*; or *2000 TNT 1-38*.)

Even though these three rulings are not the first rulings on this issue, they are very significant. Because private letter rulings cannot be cited as precedent, repeated rulings on the same issues are more indicative of a Service position than a single ruling. The pre-section 512(b)(17) rulings, the congressional approval of those rulings in the legislative history, the 1999 ruling, and these three rulings provide a consistent pattern. It seems safe to assume that, except for insurance income that is taxed under section 512(b)(17), CRUTs and other exempt organizations can use foreign corporations to avoid UBTI from debt-financed income. The current rulings also make clear that exempt organizations whose own activities are not substantial enough to warrant establishing a foreign corporation can obtain the same benefits by investing in a limited partnership that creates a foreign corporation. Although the ruling does not specify the country in which the corporation was formed, it was presumably a tax haven country so that no tax was payable in that country.

It should be noted that the success of this strategy depends upon the foreign corporation being recognized as a separate entity. The Service did not discuss this issue directly but dealt with it indirectly by stating in the facts of the ruling that: the Foreign Corporation would observe corporate formalities; would be operated as a separate entity; would invest for its own account and not as an agent for the Limited Partnership; and was being created by the Limited Partnership for real and substantial business purposes.[1] The Service also cited *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943), the seminal case on this issue, in its statement of the law.

Endnote

[1]It is interesting that the Service listed avoidance of UBTI as one of the business purposes for creating the Foreign Corporation. Avoidance of federal income taxes is not generally recognized as a business purpose for federal income tax purposes. *See, e.g., National Investors Corp. v. Hoey*, 144 F.2d 466, 468 (2d Cir. 1944).