



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

M =

Q =

X =

Dear :

This is in response to a letter dated October 4, 2004 and subsequent correspondence, requesting a ruling that certain proposed contractual relationships will not generate unrelated business taxable income under section 512(a)(1) of the Internal Revenue Code (the "Code") to M.

M is exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and has been classified as an educational organization under sections 509(a)(1) and 170(b)(1)(A)(ii).

M is the trustee of a number of charitable remainder trusts (collectively, "the Trusts"), and as trustee, M is the legal owner of the Trusts' assets. In addition, M has a remainder interest in each of the Trusts. The charitable remainder trusts distribute to individual beneficiaries either a "unitrust" amount equal to a percentage of the market value of trust assets, annual net income, or an annuity amount, with the remainder interest distributed in either case to M after a term of years or upon the death of the life beneficiaries.

As a result of its relationship with the Trusts as both trustee and beneficiary, M has a substantial interest in the value of each Trust. Moreover, the donors to the Trusts have funded the Trusts with the intention that M benefit substantially from the assets of the Trusts, and that the assets will be managed to achieve the greatest possible return on investment. In this

regard, donors often express their desire for the return on the assets to match the return on M's endowment, or for the assets to participate in the return on the endowment. Donors have expressed their concern when the investment return of a Trust has been lower than the return on M's endowment.

M's endowment is invested in traditional publicly traded assets and private investments. M's traditional publicly traded assets are divided between stocks and bonds. M's private investments consist of venture capital, leveraged buyouts, real estate, hedge funds, natural resources, and real estate. Real estate and certain other venture investments are undertaken primarily through partnership structures. Much of the income earned by the portfolio consists of passive dividends, interest, rents, and long and short-term capital gains, but some income is debt-financed or otherwise treated as unrelated business taxable income. M has provided information showing that the endowment has outperformed the Trusts on an annualized return basis in most years.

M would like to achieve greater economies of scale in the management of the Trusts, a potentially higher investment return for the Trusts, and increased diversification of the Trusts' investments. M seeks to accomplish these goals by enabling the Trusts to participate, albeit indirectly, in the return on M's endowment. M proposes to create a contractual obligation, pursuant to which it would issue a contract right to each of the Trusts for a proportionate share represented by a Q. The cumulative value of each Q would be the dollar value of the assets held by the individual Trusts combined with the Q of the endowment held by the various departments and schools at M. The contract right would entitle the Trusts to receive periodic payments based on the Q owned by each of the Trusts. The Trusts would thereby be able to receive an investment return equal to that of the endowment.

M states that it uses a "Q" concept internally with respect to the various restricted funds at the university. Each department's or division's X receives a proportionate share of the endowment return, based on the investment performance and value of the underlying endowment.

X determines a spending rate on the endowment each year based in part on the endowment's investment performance. M, through a custodian bank, calculates the market value of each Q on a monthly basis. The market value of each Q initially equals the value of the gift contribution to the endowment and is subsequently adjusted in accordance with the market value of the endowment. Each department and division is entitled to a payout in an amount equal to the spending rate times the value of the X held by each respective department and division.

The value of the endowment increases as more gifts are made to M. Funds such as those generated by tuition, government grants, or other sources of expendable funds are accounted for separately.

M seeks to enable the Trusts to invest in the endowment in a manner identical to a department or school of M. A Trust would acquire a Q in the endowment which would give the Trusts a contractual right against the University, but no interest whatsoever in the underlying investment assets of the endowment. Q, which would give the Trust a contractual right against

M, but no interest whatsoever in the underlying investment assets of the endowment. The contract between M and the Trusts would provide that the Q would equal to the contribution value at the time of acquisition. The Q would have the same value that M uses for internal accounting purposes.

The contract would provide that each Trust would receive payments on the Qs held by it equal to the spending rate M establishes for the endowment, with trust distributions made as required by the trust instrument. A Trust could choose either to reinvest part of the distribution, or liquidate a portion of the Qs, depending on its cash requirements. The Trusts will treat payouts as ordinary income, regardless of the character of the underlying income of the Q, whether capital gain, ordinary income, or return of capital, and regardless of whether the payout is made entirely by distributions of income or in part by liquidation. The Trusts will treat liquidations. The Trusts will treat liquidations (over and above receipt of the spending rate) as generating long or short-term capital gain (or loss), depending on the holding period of the liquidated portion of the Q.

Under the contract, the Trusts would not have any ownership interest in the underlying assets of the endowment or any contract rights with respect to the other trusts. The Trusts would have no power or right of any kind to control, direct, supervise, recommend or review M's business activities, operations, or decisions with respect to the endowment, except the right to review the payout computations. They would not have the right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of Qs, M is neither a partner nor an agent of the Trusts; that the Trusts would never be or become liable for any cost, expense, or payment incurred or due by M or for which M is liable or responsible relating to the Q (or the underlying Q assets), and M would indemnify and hold the Trusts harmless from and against any liability arising out of any action or inaction by M with respect to the endowment (or the underlying Q assets).

M will not charge any fee for managing the Qs of the Trusts. The bulk of M's investments are managed by a variety of external investment management firms. Those management firms typically charge a fee and receive reimbursement for expenses incurred in the process of managing the fund. Those fees and expenses are charged against the aggregate return of the endowment and either directly or indirectly reduces M's total return on its endowment. Consequently, these fees will be reflected indirectly in the spending rate payments to be made to the Trusts.

M has the right to be reimbursed for reasonable and necessary expenses incurred in connection with oversight of the portfolio investments of its endowment. M may also recover reasonable and necessary expenses of administering the Trusts, such as tax return preparation. The costs of such tax return preparation may be charged to those Trusts requiring the tax return preparation and such expenses will be reflected in the value of the Qs held by the Trusts. M does not and will not charge the Trusts any additional management fee beyond recovery of the expenses.

M has the sole remainder interest in the Trusts.

You have requested the following ruling:

The issuance of Qs by M for the Trusts, the making or receipt of payments with respect to the Qs, and the holding or liquidation of the Qs, will not generate unrelated business taxable income to M or the Trusts.

Your original request included charitable lead trusts in the definition of Trusts. We are not issuing a ruling to one or more of M's charitable lead trusts. Thus, the word "Trusts" as used in this letter refers only to M's charitable remainder trusts, and the ruling issued by this letter relates only to the participation by M's charitable remainder trusts in M's Q.

We are concerned that non-charitable beneficiaries may benefit inappropriately from deferrals that can be controlled and designed for tax benefit. Therefore, we are studying whether it remains appropriate to characterize the transaction as a contract when a charitable lead trust is involved, and whether it is appropriate to conclude that a charitable lead trust will realize unrelated trade or business income. Accordingly, we will decline to issue a ruling concerning the participation by a charitable lead trust as an investor in M's Q.

LAW

Section 511 of the Code, in part, imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

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

Section 512(b) of the Code sets forth so-called "modifications," which are excluded from the computation of unrelated business taxable income. These modifications include dividends, interest, royalties, rent from real property, and gain from the sale of property.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) of the Code provides that the term "trade or business" includes any activity, which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(a) of the Income Tax Regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 of the Code the term "trade or business" has the same meaning it has in section 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization that was formed to provide investment services on a fee basis exclusively to organizations exempt under section 501(c)(3) of the Code. It receives funds from the participating exempt organizations, invests in common stocks, reinvests income and realized appreciation, and upon request liquidates a participant's interest and distributes the proceeds to the participant. The Rev. Rul. states that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. If the services were regularly provided by one tax-exempt organization for other tax-exempt organizations, such activity would constitute unrelated trade or business. The Rev. Rul. holds that the organization is not exempt under section 501(c)(3)

As noted previously, organizations described in section 501(c)(3) of the Code are subject to tax on their unrelated business income under section 511. In order for such an organization's income to be subject to the unrelated business income tax, three requirements must be met: (1) the income must be from a trade or business; (2) the trade or business must be regularly carried on; and (3) the conduct of the trade or business must not be substantially related to the organization's exempt purpose or function. See section 1.513-1(a) of the regulations.

ANALYSIS

M proposes to enter into a contractual relationship with certain Trusts that are charitable remainder trusts in which M has an interest as a beneficiary and serves as trustee of the Trust. Under such a contractual relationship, each Trust would receive payments on the Qs held by it equal to the payout rate X establishes for its endowment, with payouts made in accordance with the trust instruments.

Each Trust would acquire a Q from M's endowment, which would give the Trusts a contractual right against M, but no interest whatsoever in the underlying investment assets of the endowment. The contract between M and the Trusts would provide that the price of the Qs would equal their value at the time of acquisition. The Qs would have the same value that M uses for internal accounting purposes.

Consequently, a Trust could choose either to reinvest part of the payout, or liquidate a portion of the Q, depending on its cash requirements. Thus, under the contractual relationship with M, the Trusts would have a right to the payout declared by M plus the right to redeem the Qs at the value that M uses for internal accounting purposes.

Generally, an organization that otherwise qualifies for recognition of exemption under section 501(c)(3) of the Code and provides investment services on a regular basis for a fee to other exempt or nonexempt organizations would be engaged in an unrelated trade or business under section 513(a). See Rev. Rul. 69-258, *supra*. Such an activity would constitute a "trade or business" under sections 513(c) and 1.513-1(b) of the regulations, and would be "regularly carried on" under sections 512(a)(1) and 1.513-1(c). Thus, if M charged a fee for investment management services provided to organizations unrelated to M or generated income from the management of the funds invested by such organizations, these activities could result in unrelated business taxable income under section 512(a)(1). Here, however, M is not charging a fee for its services and not otherwise receiving income from the services it provides to the Trusts. Thus, under these circumstances, M will not receive unrelated business taxable income under section 512(a)(1).

The fact that M will engage in the investment activity for the benefit of individuals who are co-beneficiaries of the Trusts at the same time that it engages in investment activity for its own benefit as the remainder beneficiary limits the scope of the service provided to "others" and distinguishes it from a commercial venture.

In view of the foregoing, we rule as follows:

The issuance of Qs from M to the Trusts, the making or receipt of payments with respect to the Qs, and the holding or redemption of the Qs, will not generate unrelated business taxable income to M.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

We express no opinion as to the tax consequences of the proposed transaction under any other section of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representatives. A copy of this letter should be kept in M's permanent records.

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

If there are 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.
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437

cc: