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:

512.00-00

Legend:

M =

Dear :

This is in response to a letter dated November 5, 2004, 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 the sole charitable 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, or a fixed 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.

M does not charge a fee for its management services, although it may recover actual costs of management as a charge against total investment return and actual costs of administration of the Trusts as a charge against the Trusts. M does not manage funds for any third parties other than the Trusts or affiliated entities.

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. M is concerned that it cannot deliver results matching the endowment, and that the Trusts cannot be diversified properly unless they can be commingled with all endowment assets.

The endowment is invested in a diversified manner, including investments in marketable securities, private equity, risk arbitrage, hedge funds, fixed income instruments, cash, and real estate. Real estate and certain other alternative investments are undertaken primarily through partnership structures. Much of the income earned by the endowment 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 stated that the return on the Trusts in recent years has been similar to the return on its endowment.

M anticipates selecting assets from more alternative asset classes in the future in which the Trusts cannot participate. M asserts that this strategy likely would create potential problems, including insufficient diversification of the Trusts and a potential for greater divergence between performance of the endowment and performance of the Trusts.

M would like to achieve greater economies of scale in the management of the Trusts, a potentially higher and more stable 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 so-called "Endowment Units." The value of the units would equal the value of the units of the endowment held by the various restricted funds at the college. The contract right would entitle the Trusts to receive periodic payments based on the number of units owned. The Trusts would thereby be able to receive an investment return equal to that of the endowment.

M states that it uses a "unit" concept internally with respect to its various restricted funds. Each fund is allocated a certain number of units of the endowment, and the value of such units is be determined by dividing the total value of the endowment investments by the number of outstanding units. M sets a distribution rate on the endowment each year based in part on the endowment's investment performance. Each fund is entitled to payment in an amount equal to the number of units held times the value per unit times the distribution rate.

M sets the value of the units on a monthly basis based on the underlying asset value of the endowment. The value of the endowment divided by the number of outstanding units equals the value of each unit. M has no other formula for valuation of the units, nor does it reserve or segregate any part of its endowment earnings from inclusion in the value of the units. The market value and number of units increase as donors complete their contributions. Funds generated from tuition, government grants, or other sources of expendable funds are accounted for separately.

M seeks to enable the Trusts to invest in the units similar to a department of M. A Trust would acquire units from M's endowment, 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 price of the units would equal their value at the time of acquisition. The units would have the same value that M uses for internal accounting purposes.

The contract would provide that each Trust would receive payments on the units held by it equal to the distribution rate M establishes for the endowment, with distributions made quarterly. A Trust could choose either to reinvest part of the distribution, or redeem additional units, depending on its cash requirements. The Trusts will treat payouts up to the distribution rate as ordinary income, regardless of the character of the underlying income of the endowment, 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 redemption of units. The Trusts will treat redemptions of units (over and above receipt of the distribution rate) as generating long or short-term capital gain (or loss), depending on the holding period of the redeemed units.

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 units, 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 endowment (or the underlying endowment 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 endowment assets). The costs of management are borne by the entire endowment, and the return paid to the Trusts will reflect those costs.

You have requested the following ruling:

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

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

Here, 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 units held by it equal to the distribution rate M establishes for its endowment, with payouts made quarterly by M.

A Trust would acquire units from the M 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 units would equal their value at the time of acquisition. The units would have the same value that M uses for internal accounting purposes.

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

Further, M will not charge a fee for its management of the Trusts, although it may recover actual costs of management as a charge against total investment return. In addition, it may recover actual costs of administration of the Trusts as a charge against the Trusts.

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. 69-528, 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 units from M to the Trusts, the making or receipt of payments with respect to the units, and the holding or redemption of the units, will not generate unrelated business taxable income to M.

The ruling issued by this letter relates only to the participation by M's charitable remainder trusts in the M endowment.

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
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