



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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509.02-02

512.01-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend

M =

Date a =

x =

Dear

This is in reply to your request for a ruling concerning the tax consequences of your contractual relationship with M under sections 509(a)(3) and 512 of the Internal Revenue Code.

Facts

M is a tax-exempt organization 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).

You are a charitable trust established under the law of the State of x. You are tax-exempt under section 501(a) as an organization described in section 501(c)(3) and are classified as a supporting organization under section 509(a)(3). You provide financial support to M and make payments of substantially all of your income to or for the benefit of M. Your trust document states that you provide financial support to M only and not to any other tax-exempt organization.

The assets in M's endowment fund ("Endowment Fund") are invested in a widely diverse manner, including substantial investments in public equities, bonds, private equity, and real estate. Much of the income earned by the Endowment Fund consists of dividends, interest, and short-term and long-term capital gains. Some of the income generated through investments in partnerships and similar pass-through entities is unrelated business taxable income under section 512 of the Code, including income from debt-financed property.

M uses a "Share" concept for the Endowment Fund as to the separate endowments established for the various schools, hospital and other units ("Participants") comprising M. Each Participant within M holding a Share of the Endowment Fund is entitled to receive monthly distributions ("Payments") based on the following methodology.

Each year, M determines a rate ("Payout Rate") at which it will make Payments to Participants. The Payout Rate is based on: (a) the income earned on the assets of the Endowment Fund; (b) the change in the value of the assets in the Endowment Fund; (c) the rate of inflation; and (d)

such other factors as M determines from time to time. Each Participant is entitled to receive Payments based on the market value of the Endowment Fund at the end of each month, the Share of the Endowment Fund held by the Participant and the applicable Payout Rate.

Since you were formed, the investment return earned on your assets has been significantly less than the investment return M has earned on the assets in its Endowment Fund. Both you and M desire for your assets to achieve the potentially higher investment return, increased diversification and greater economies of scale offered by the Endowment Fund. To accomplish this, on Date a, you entered into an Investment Agreement with M. Pursuant to this agreement, you transferred virtually all of your assets to M's Endowment Fund.

Under the Investment Agreement, you are entitled to receive Payments based on the Share in the Endowment Fund you hold and the current Payout Rate. You treat Payments from the Endowment Fund as ordinary income, regardless of the character of the underlying income, whether capital gain, ordinary income, or return of capital. You may direct M to reinvest all or a portion of Payments. You also have the right to make additional transfers to the Endowment Fund and to make withdrawals from time to time. If you reinvest or transfer additional funds to the Endowment Fund, your Share will increase. Similarly, if you withdraw funds from the Endowment Fund ("Redemption"), your Share will decrease.

Under the Investment Agreement, M owns the assets in the Endowment Fund. Accordingly, you do not have any ownership interest in any of the assets in the Endowment Fund or have any rights to or interest in the income derived from the Endowment Fund. Your rights to receive Payments from the Endowment Fund and to make Redemptions are contractual rights pursuant to the Investment Agreement.

In the Investment Agreement, you and M acknowledge that your relationship to each other constitutes neither a partnership nor a co-ownership arrangement, and you represent that your relationship to M does not constitute a partnership for federal income tax purposes. You 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 Fund. You have no right to veto or opt out of any of the underlying investments of the Endowment Fund. You are not responsible for, and do not have any liability for any fees, costs, expenses or other charges assessed or incurred by M as to the Endowment Fund. Further, M has agreed to indemnify, defend and hold you harmless from and against all claims, actions, judgments, damages, liabilities, costs and expenses incurred by or asserted against you as a result of any action or inaction by M as to the Endowment Fund or any of its assets.

M does not charge a fee for its management services of the Endowment Fund and does not manage funds for any third parties other than Participants. M does not charge you any investment management fee. M does not intend to manage funds for any private individual.

Rulings Requested

1. Your receipt of a Share in the Endowment Fund, your receipt of Payments from the Endowment Fund with respect to your Share, and your Redemption of any part of your

Share in the Endowment Fund, will not generate unrelated business taxable income under section 512 of the Code.

2. For purposes of the "integral part test" in section 1.509(a)-4(i)(3)(iii)(a) of the regulations, in determining whether you distribute "substantially all" of your "income" to M: the term "income" includes all Payments you receive from the Endowment Fund under the Investment Agreement, whether you distribute Payments to or for the benefit of M, reinvest Payments in the Endowment Fund, or otherwise retain Payments; and Payments you distribute to M will be counted toward determining whether you meet the "substantially all" test.

Law and Analysis

Ruling Request No. 1

Law

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(c) of the Code and section 1.512(c)-1 of the regulations provides that if a trade or business regularly carried on by a partnership of which a tax-exempt organization is a member is an unrelated trade or business with respect to the organization, the organization must include its share of the gross income of the partnership from the unrelated trade or business.

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 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 the term "trade or business" has the same meaning it has in section 162 of the Code 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 a 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.

Rev. Rul. 69-574, 1969-2 C.B. 130, involved interest income received by a tax-exempt employees' trust on customer notes it purchased from its sponsoring employer. This revenue ruling concluded that this interest income, because it is primarily passive in nature, does not constitute unrelated business taxable income to the trust within the meaning of section 512 of the Code.

Analysis

You are tax-exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and are classified as a supporting organization under section 509(a)(3). You provide financial support to M and make payments of substantially all of your income to or for the benefit of M. In order to improve the investment return earned on your assets, to increase diversification and greater economies of scale, you entered into the Investment Agreement with M, pursuant to which you transferred virtually all of your assets to M's Endowment Fund. Under the Investment Agreement, you receive Payments from the Endowment Fund based on the Share in the Endowment Fund you hold and the current Payout rate.

Under the Investment Agreement, M owns the assets in the Endowment Fund. Accordingly, you do not have any ownership interest in any of the assets in the Endowment Fund nor have any rights to or interest in the income derived from the Endowment Fund. Your rights to receive Payments from the Endowment Fund and to make Redemptions are contractual rights pursuant to the Investment Agreement.

In the Investment Agreement, you and M acknowledge that your relationship to each other constitutes neither a partnership nor a co-ownership arrangement. In addition, you represent that your relationship to M does not constitute a partnership for federal income tax purposes. You 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 Fund. You have no right to veto or opt out of any of the underlying investments of the Endowment Fund.

For any income of an organization described in section 501(c) of the Code to be subject to the unrelated business income tax under section 512, section 1.513-1(a) of the regulations states that 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.

Your arrangement with M under the Investment Agreement, including your receipt of a Share in the Endowment Fund, your receipt of Payments from the Endowment Fund pursuant to the Investment Agreement, and your Redemption of any part of your Share in the Endowment constitute investment activities rather than a trade or business regularly carried on within the meaning of section 1.513-1(b) and 1.513-1(c) of the regulations. Furthermore, these activities will generate income that is primarily passive in nature, similar to the arrangement described in Rev. Rul. 69-574, supra. Accordingly, because these activities fail the first two requirements described in section 1.513-1(a), they will not generate unrelated business taxable income under section 512 of the Code.

Ruling Request No. 2

Law

Section 509(a)(3) of the Code defines the term "supporting organization" as one which is organized and operated exclusively for the benefit of, to perform the functions of, or carry out the purposes of, one or more specified organizations described in sections 509(a)(1) or 509(a)(2), and is not controlled by one or more disqualified persons.

Section 1.509(a)-4(f)(2) of the regulations states that one of the required relationships under section 509(a)(3) of the Code between a supporting organization and the supported organization is that the supporting organization is operated in connection with one or more publicly supported organizations.

Section 1.509(a)-4(i)(1)(i) of the regulations provides that a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" in section 1.509(a)-4(i)(2) and the "integral part test" in section 1.509(a)-4(i)(3).

Section 1.509(a)-4(i)(3)(i) of the regulations states that a supporting organization will be considered to meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such organizations are in turn dependent upon the supporting organization for the type of support which it provides. In order to meet this test, the supporting organization must satisfy the requirements of either section 1.509(a)-4(i)(3)(ii) or section 1.509(a)-4(i)(3)(iii).

The requirement in section 1.509(a)-4(i)(3)(iii)(a) of the regulations is that: "The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations," and the amount of support received by the publicly supported organization is sufficient to insure its attentiveness to the operations of the supporting organization.

Section 4942 of the Code imposes excise taxes on the undistributed income of a private foundation. This tax, however, does not apply to the undistributed income of a private foundation for any taxable year for which it is an operating foundation, as defined in section 4942(j)(3).

Section 4942(f) of the Code defines the term "adjusted net income" as the excess of "the gross income" for the taxable year, determined with the income modifications described in section 4942(f)(2), over the sum of the deductions, determined with the deduction modifications described in section 4942(f)(3), that would be allowable to a taxable corporation.

Section 4942(j)(3) of the Code defines an operating foundation as any organization that meets several requirements. One requirement is that it make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of its adjusted net income, as defined in section 4942(f).

Section 53.4942(b)-1(c) of the regulations states that for purposes of section 4942 of the Code, the term "substantially all" means 85 percent or more.

Rev Rul. 76-208, 1976-1 C.B. 161, concluded that, although the term "substantially all" is not defined in section 1.509(a)-4(i)(3) of the regulations as meaning 85 percent or more, for purposes of the "integral part test" in section 1.509(a)-4(i)(3), the term "substantially all" is considered to have the same meaning of 85 percent or more that it has in section 53.4942(b)-1(c).

Analysis

Under section 1.509(a)-4(i)(1) of the regulations, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets two tests, one of which is the "integral part" test in section 1.509(a)-4(i)(3). A supporting organization will meet this test if it maintains a significant involvement in the operations of one or more publicly supported organizations and such organizations are in turn dependent upon the supporting organization for the type of support which it provides. To meet this test, the supporting organization must meet one of two alternative requirements. One requirement, in section 1.509(a)-4(i)(3)(iii)(a), states that the organization must make payments of substantially all of its income to or for the use of one or more publicly supported organizations. However, for the purpose of this test, the term "income" is not defined in this regulation.

Section 1.509(a)-4(i)(3) of the regulations, relating to the "integral part test, does not define the term "substantially all." However, this term is also used in section 53.4942(b)-1(c), where it is defined as meaning 85 percent or more. Rev. Rul. 76-208, supra, concludes that for purposes of the "integral part test" in section 1.509(a)-4(i)(3), the term "substantially all" is considered to have the same meaning of 85 percent or more that it has in section 53.4942(b)-1(c).

Therefore, for purposes of the "integral part test" in section 1.509(a)-4(i)(3)(iii)(a) of the regulations, in determining whether you distribute "substantially all" of your "income" to M, the term "income" includes all Payments you receive from M's Endowment Fund under the Investment Agreement, whether you distribute Payments to or for the benefit of M, reinvest Payments in the Endowment Fund, or otherwise retain Payments. Payments you distribute to M will be counted toward determining whether you meet the "substantially all" test.

Rulings

1. Your receipt of a Share in the Endowment Fund, your receipt of Payments from the Endowment Fund with respect to your Share, and your Redemption of any part of your Share in the Endowment Fund, will not generate unrelated business taxable income under section 512 of the Code.
2. For purposes of the "integral part test" in section 1.509(a)-4(i)(3)(iii)(a) of the regulations, in determining whether you distribute "substantially all" of your "income" to M: the term "income" includes all Payments you receive from the Endowment Fund under the Investment Agreement, whether you distribute Payments to or for the benefit of M, reinvest Payments in the Endowment Fund, or otherwise retain Payments; and Payments that you distribute to M will be counted toward determining whether you meet the "substantially all" test.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Steven Grodnitzky
Manager
Exempt Organizations
Technical Group 1

Enclosure
Notice 437