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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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February 13, 2009

UIL: 512.00-00
Legend:

University System =
Board =
Management Corp. =
Fund A =
Endowment Fund =
Trust =

Dear :

We have considered your ruling request dated October 1, 2007, and your amended ruling request dated June 24, 2008, concerning the federal income tax consequences under section 512 of the Internal Revenue Code of 1986, as amended (hereafter "Code"), related to a proposed contractual arrangement in the manner and for the purposes described below.

Facts:

The University System has been established pursuant to the state's constitution and statutes to provide for the higher education of students within the state. Specifically, the state's constitution provides for the establishment of the University System for the promotion of literature, arts and sciences. The Board is the governing body of the University System, with the state's University System composed of several academic and health-related institutions of higher education. The University System is a governmental unit described under sections 170(b)(1)(A)(v) and 170(c)(1) of the Code and exempt from taxation. The state's statutes provide that the Board is specifically authorized and directed to govern, operate, support and maintain the state's University System, which includes promulgating and enforcing rules and regulations for the operation of the state's University System. The state's constitution designates the Board as the fiduciary over any endowment funds established to provide financial support for the various educational organizations that comprise the state's University System. As authorized by state statute, the Board assesses each endowment fund certain administration and management fees, which fees provide funding for administrative costs directly related to the management of endowments and to ensure institutional compliance with the agreements made with endowment donors.

Management Corp. was established by the Board pursuant to the state's constitution and statutes. Management Corp. has been recognized as a tax-exempt entity under section 501(c)(3) of the Code and as an entity described in section 509(a)(3) that is organized to support the state's University System. As a supporting organization to the University System, all directors of Management Corp, other than the Chancellor of the University System, are appointed by and serve at the pleasure of the Board. Pursuant to Management Corp.'s Articles of Incorporation, its charitable purpose is to aid, assist, support and act on behalf of the University System, which is governed by the Board. Management Corp.'s Articles of Incorporation lists its specific purpose as investing funds under the control and management of the Board, which includes the management of Fund A and Endowment Fund, and the performance of such other activities or functions that the Board determines as necessary to accomplish its charitable purpose, except that it may not engage in any business other than investing funds designated by the Board.

Fund A is a general pooled endowment fund that is comprised of two sub funds, one of which is Endowment Fund. Neither Fund A nor the Endowment Fund is a pooled income fund as described in section 642(c)(5) of the Code. Endowment Fund is a pooled fund for the collective investment of privately raised endowment funds. All funds are held solely for the benefit of the University System and its controlled entities of higher education. Endowment Fund is heavily diversified in both domestic and international markets and utilizes alternative investment strategies to reduce the overall risk of the portfolio and to enhance investment returns. Much of the income earned by Endowment Fund consists of passive dividends, interest, rents and long-and short-term capital gains, but some income is debt financed or otherwise is treated as unrelated business taxable income. As the managing and investing agent for the University System's funds, including Fund A and Endowment Fund, Management Corp. incurs expenses associated with the investment management and administration of these assets. Management Corp. represents that it submits an annual budget to the Board reflecting all estimated expenses associated with the management of all assets under its control. The budget includes Management Corp.'s "management fee," which is comprised of (i) all operating expenses associated with the general management of all funds under management, (ii) a capital expenditures budget, and (iii) the direct expense of the funds associated with strategy and analysis, portfolio management, custody and safekeeping, accounting and other investment related functions. After the budget is approved by the Board, the management fee is charged against the aggregate return of the funds, including Endowment Fund. Management Corp. reports that all fees are charged at the fund level and no fees are charged to the individual unit holders.

The Board is both the trustee and sole charitable remainder beneficiary of Trust. Trust is a charitable remainder unitrust described under section 664(d)(2) of the Code. Under the terms of Trust's agreement, Trust's donor is the income beneficiary entitled to an annual payout of a unitrust amount equal to a percentage of the net fair market value of Trust's assets pursuant to section 643(b) of the Code. The remainder interest is distributable to the Board, for the benefit of the University System, upon the death of the income beneficiary. Presently, Trust assets are managed by various investment managers in accordance with a strategy developed by an outside for-profit advisor. The Board reports that as trustee and remainder beneficiary of Trust's assets, it desires to provide the level of diversification and rate of return on Trust's assets as those achieved on University System's Endowment Fund. Therefore, in an attempt to increase Trust's diversification and investment return, the Board proposes to take advantage of the concept of economies of scale, by entering into a contract with itself (both as fiduciary of the University System's Endowment Fund and as fiduciary of Trust's assets) and allow Trust to commingle its assets with those of the Endowment Fund. A higher rate of return on Trust's assets would cause its donor to receive a higher unitrust payout, and would cause the University System to ultimately receive a higher final payment as the remainder beneficiary.

The Board proposes to enable Trust to participate in the University System's Endowment Fund through the acquisition of "units." The Board proposes to create a contractual obligation, pursuant to which it will issue to Trust a contract right, called units, in the Endowment Fund in exchange for Trust investing its assets in the Endowment Fund. The number of units Trust will receive will be in proportion to the value of Trust's investment in the Endowment Fund. The contract will provide that Trust will receive an income payout based on the number of units owned and the payout rate established by the Board for the Endowment Fund. The Board represents that any fund investment return over and above the payout rate is credited to the principal amount of the fund and is reflected as an increase in the value of each unit outstanding. The value of the units, both at the time of acquisition and redemption, will be based on the value of all underlying investment assets held in the Endowment Fund. The contract provides that Trust could choose to either reinvest part of the payout, or redeem additional units, depending on Trust's cash requirements. The payout (up to the endowment fund spending rate) will be characterized as ordinary income to Trust, regardless of whether the underlying income to the endowment fund is characterized as capital gain, ordinary income, or a return of capital. The holding period of a particular unit will be treated as beginning on the date the unit is issued to the Trust. Redemptions of units by Trust (over and above receipt of the payout rate) will be treated as either long- or short-term capital gain (or loss), depending on the holding period of the units. Furthermore, the Board will pay any tax owed on unrelated business taxable income earned by the Endowment Fund.

The Board represents that under the contract, Trust would not have any ownership interest in the underlying assets of the Endowment Fund, or any contract rights with respect to other trusts. Trust would have no power or right of any kind to control, direct, supervise, recommend or review the Board's business activities, operations, or decisions with respect to the Endowment Fund, except the right to review the payout computation. Trust would not have the right to veto or opt out of any of the underlying investments in the Endowment Fund. The contract would provide that, with respect to the issuance of units, neither the Board nor the University System is a partner with Trust or an agent of the Trust. Trust would also never be or become liable for any cost, expense, or payment incurred or due by the Board or for which the Board is liable or responsible relating to the Endowment Fund (or the underlying endowment assets), and the Board would indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by the Board with respect to the Endowment Fund (or the underlying assets). Trust's liability will be limited to the risk of loss of its capital invested in the contract with the Board.

As to the issue of fees and cost, the Board states that it "will not charge the Trusts a fee for administrative and management services." The Board represents that it will not generate any income from the investment management of the Trust, even if there is a spread between the Endowment Funds' earnings and the declared payout. However, the Board represents that it is authorized by state statute to assess fees for the administration of the Endowment Fund. The Board also represents that the investment management costs will be borne proportionally by each unit holder in the Endowment Fund and the payout will reflect these costs. Furthermore, as to the issue of Management Corp.'s expenses, the Board represents that Management Corp. submits a annual budget to the Board, reflecting all estimated expenses associated with the management of all assets under its control. Only after the Board approves the budget are any expenses charged to the funds, with all expenses charged proportionally to each fund, and not directly to the Trust or individual unit holders.

You have requested the following rulings:

1. The issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to these units, and the holding or redemption of these units will not generate unrelated business taxable income to the Board.

2. The issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to these units, the participation of Trust in Fund A and the Endowment Fund, including the payment of fees and expenses to Management Corp., and the holding or redemption of these units will not generate unrelated business taxable income to Management Corp.

3. The issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to these units, and the holding or redemption of these units will not generate unrelated business taxable income to Trust.

4. The redemption of Endowment Fund units by Trust will be treated as long- or short-term capital gain or loss, depending upon the holding period of these units.

<u>Law</u>:

Section 501(c)(3) of the Code, in part, provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, educational, scientific, and certain other purposes.

Section 511(a) of the Code, in part, imposes a tax on the unrelated business taxable income of certain organizations exempt from taxation, including "any college or university that is an agency or instrumentality of any government..."

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 excludes from the definition of unrelated business taxable income all dividends, interest, payments with respect to securities loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income. It also excludes all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income. It also excludes certain rents.

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 the 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 "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. An activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 664(d)(2) of the Code defines a charitable remainder unitrust as a trust (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals; (B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c); (C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g)); and, (D) with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

Section 1221 of the Code defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in section 167, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States Government; (6) certain commodities financial derivatives; (7) certain hedging transactions; and (8) supplies of a type regularly consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Section 1222 of the Code provides that capital gain or loss is generated upon a sale or exchange of a capital asset.

Section 1234A of the Code provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

Section 1.512(b)-1(a)(1) of the Income Tax Regulations (hereafter "regulations") defines certain investment income to include dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulation 26 CFR 1.863-7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and further provides that the foregoing investment income, and all deductions directly connected with the foregoing investment income, shall be excluded in computing unrelated business taxable income.

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 the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 — and which, in addition, is not substantially related to the performance of exempt functions — presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 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. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose their identity as a trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose their identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

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.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from an "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 and 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 a 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 (other than through the production of income), 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 a 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.

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. The organization received funds from participating exempt organizations and invested the proceeds in stocks, reinvested the income and realized appreciation, and upon request, liquidated participant's interests and distributed the proceeds to the participant. The Service held that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The Service further held that the activity would constitute an unrelated trade or business even if the services were regularly provided by one tax-exempt organization for other tax-exempt organizations. Thus, the Service concluded that the organization was not tax exempt under section 501(c)(3) because it was regularly carrying on a business of providing investment services that would be an unrelated trade or business if carried on by any of the tax-exempt organizations on whose behalf it operated.

Commissioner v. Ferrer, 304 F.2d 125 (2[d] Cir. 1962), the Court held that the taxpayer's surrender of a lease of a play constituted the sale or exchange of a capital asset, despite the fact that receipts from the play would have been ordinary income. In its rejection of the government's argument against capital gain treatment, the Court noted that there was no equivalence between amounts paid for the surrender of the lease and the income that would have been realized by its retention.

Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960) (citing Burnet v. Harmel, 287 U.S. 103 (1932)), the United States Supreme Court found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of section 1221] qualifies as a capital asset;" rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ...."

Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958), the United States Supreme Court denied capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas interests.

Elliot v. United States, 431 F.2d 1149 (10th Cir. 1970), the Court denied capital gain treatment for the lump sum payment representing the surrender of rights to future sales commissions.

Freese v. United States, 455 F.2d 1146 (10th Cir. 1972), the Court denied capital gain treatment for the lump sum payment representing unpaid commissions due under an employment contract.

Guggenheim v. Commissioner, 46 T.C. 559, 569 (1966), the Tax Court focused on whether the taxpayer transferred substantial investment risks in the sale of undivided interests in a stallion. There, the court noted that if the value of the stallion subsequently increased, the taxpayer would not share in that increase with regard to the interests transferred. Instead, the new owners received all the benefits of an increase in value of the stallion, and all the burdens of a decrease in value. Thus, the Court found that the taxpayer had transferred substantial investment risks and was entitled to capital gain treatment on the sale of the interests.

Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962), the Court denied capital gain treatment for the payment for interest in films to be produced by taxpayer.

Hort v. Commissioner, 313 U.S. 28 (1958), the taxpayer inherited a building, and subsequently one of the tenants canceled their lease, paying the taxpayer a cancellation fee. The United States Supreme Court held that the cancellation fee was ordinary income because the cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises.

Lattera v. Commissioner, 437 F.3d 399 (3rd Cir. 2006), the Court denied capital gain treatment for interests relating to payment for annual installments of a lottery prize.

Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942), the Court denied capital gain treatment for interests relating to the right to a declared dividend.

United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963), the Court distinguished between proceeds from the present sale of the future right to earn income, which is capital gain, and the present sale of the future right to earned income, which is ordinary income. The Court found that the sale of an income-producing asset was not merely the sale of the right to income already earned; instead, the taxpayer had an asset that would produce income in the future. Thus, the Court held that the taxpayer's sale of the asset generated capital gain.

United States v. Midland-Ross Corp., 381 U.S. 54 (1965), the Court denied capital gain treatment for interests relating to income earned on original issue discount.

Analysis:

Ruling 1:

The issue is whether the Board will incur unrelated business taxable income upon the issuance of Endowment Fund units to Trust, upon the making or receipt of payments with respect to these units, and upon the holding or redemption of these units.

Section 511 of the Code imposes a tax on the income earned by a governmental unit described under sections 170(b)(1)(A)(v) and 170(c)(1) of the Code and exempt from taxation, if the income results from the operation of the organization's unrelated trade or business. An organization that engages in a trade or business will have unrelated trade or business taxable income if three conditions are satisfied: (1) the trade or business generates income; (2) the trade or business is regularly carried on; and (3) the trade or business is unrelated to the organization's exempt purpose or function. See, Section 512(a)(1); section1.513-1(a) of the regulations. The term trade or business has the same meaning for purposes of section 513 as it does for 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(b).

Generally, an organization that otherwise qualifies for recognition of tax-exemption 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 the Board charged a fee for investment management services provided to organizations unrelated to it 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, the Board is not charging a fee for its services and not otherwise receiving income from the services it provides to the Trust. Thus, under these circumstances, the Board will not receive unrelated business taxable income under section 512(a)(1).

The fact that the Board will engage in the investment activity for the benefit of an individual who is a co-beneficiary of the Trust at the same time that it engages in investment activity for its own benefit as the charitable remainder beneficiary limits the scope of the service provided to others and distinguishes it from a commercial venture.

The relationship between the Board and Trust is also distinguishable from Rev. Rul. 69-258, in which the Service held that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit, and that the activity would constitute an unrelated trade or business even if the services were regularly provided by one tax-exempt organization for the benefit of other tax-exempt organizations. Because the Board is not charging any fees (over and above its costs) for investing in the Endowment Fund and because the Board is investing funds on its own behalf as sole remainder beneficiary and as trustee, Rev. Rul. 69-258 is not applicable.

Ruling 2:

The issue is whether Management Corp. will incur unrelated business taxable income upon the issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to the units, the participation of Trust in Fund A and Endowment Fund, including the payment of fees and expenses to Management Corp., and the holding or redemption of units.

As stated fully above, section 511 of the Code imposes a tax on the income earned by organizations recognized as tax-exempt, if the income results from the operation of the organization's unrelated trade or business. See, Section 512(a)(1); section1.513-1(a) of the regulations. The proposed contractual relationship between the Board and Trust, in which Trust will invest in the University System's Endowment Fund, which fund is managed by Management Corp., will not give rise to unrelated business taxable income to the Board under the facts presented whether or not the Board manages the fund directly or has a supporting organization manage the fund on the Board's behalf.

Management Corp. is a supporting organization of the state's University System dedicated solely to the management of investment assets under the control of the Board. These assets include Fund A and the Endowment Fund. Management Corp. reports that it does not earn any net income from its management duties. Rather, pursuant to Board's approval of Management Corp.'s annual budget, Management Corp. only recovers its "management fee" as a charge against the aggregate return of the funds it manages. This management fee is comprised of (i) all operating expenses associated with the general management of all funds under management, (ii) a capital expenditures budget, and (iii) the direct expense of the funds associated with strategy and analysis, portfolio management, custody and safekeeping, accounting and other investment related functions. Management Corp. furthers its tax-exempt purpose by engaging in investment activity solely on behalf of the Board, which is both the trustee and remainder beneficiary of Trust, and Management Corp.'s supported organization, the University System. As such, Trust's donor, as life beneficiary, becomes an incidental beneficiary to Management Corp.'s activities, distinguishing Management Corp.'s activities from those of the organization described in Rev. Rul. 69-258. Therefore, Management Corp.'s activities do not give rise to unrelated business taxable income.

Ruling 3:

The issue is whether the issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to the units, and the holding or redemption of the units will generate unrelated business taxable income to Trust.

As stated above, under the contract, Trust would neither have any ownership interest in the underlying assets of the endowment nor any contract rights with respect to other trusts. Trust 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. Trust would not have any right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of Endowment Fund units, neither the Board nor the University System is Trust's partner or agent, and that Trust would never be or become liable for any cost, expense, or payment incurred or due by the Board or for which the Board is liable or responsible relating to the endowment (or the underlying endowment assets), and finally, the Board would indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by the Board with respect to the endowment (or the underlying endowment assets).

The Trust does not have a position of ownership in the underlying assets of the endowment. Because the contractual relationship between the Board and Trust is not in the nature of a partnership or agency, the income earned by Trust from the payout established for the units reflects ordinary income and does not take on the character of the income of the underlying assets, or of debt-financed income, or of unrelated business taxable income. The Board would pay any tax owed on unrelated business taxable income earned by the endowment portfolio, with no deduction taken against unrelated business taxable income for any payments made to the Trust.

Therefore, Trust will not incur unrelated business taxable income upon investing in the University System's Endowment Fund through Fund A, assuming that Trust does not incur an acquisition indebtedness with respect to the investment giving rise to unrelated debt-financed income under sections 512(b)(4) and 514 of the Code. As discussed below in greater detail, gain or loss from the redemption of units will give rise to dispositions of property described in section 512(b)(5).

Ruling 4:

The issue is whether the redemption of units by Trust will be treated as long- or short-term capital gains or loss, depending upon the holding period of the trust units.

Section 1222 provides that capital gain or loss is generated upon a sale or exchange of a capital asset. Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States Government; (6) certain commodities financial derivatives; (7) certain hedging transactions; and (8) supplies of a type regularly consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Based upon the transaction described above, none of the listed exceptions in section 1221 of the Code apply. However, although section 1221 appears to give broad meaning to the term capital asset, the Supreme Court has found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of section 1221] qualifies as a capital asset;" rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ...." Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960) (citing Burnet v. Harmel, 287 U.S. 103 (1932)). Accordingly, the Court has held that certain interests that are concededly "property" in the ordinary sense are not capital assets.

On this basis, capital gain treatment has been denied for transactions involving payments in return for interests carved out of, or related to, an interest retained by the taxpayer. See e.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (denying capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas interests); Hort v. Commissioner, 313 U.S. 28 (1958) (denying capital gain treatment on the disposition of a term of years carved out from a fee simple).

The Courts have also denied capital gain treatment for transactions on the basis that the payments at issue were a substitute for ordinary income. In Hort, for example, the taxpayer inherited a building, and one of the tenants canceled its lease, paying the taxpayer a cancellation fee. The Court held that the cancellation fee was ordinary income because the cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Id. at 32. The Court bolstered this "substitute-for-ordinary-income" doctrine in P.G. Lake, stating, "[t]he lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." P.G. Lake, 356 U.S. at 265.

Consistent with the substitute-for-ordinary-income doctrine, courts have denied capital gain treatment for transactions involving interests related to compensation for past or future personal services. See, e.g., Freese v. United States, 455 F.2d 1146 (10th Cir. 1972) (lump sum representing unpaid commissions due under an employment contract); Elliot v. United States, 431 F.2d 1149 (10th Cir. 1970) (lump sum paid for the surrender of right to future sales commissions); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (payment for interest in films to be produced by taxpayer). Similarly, courts have denied capital gain treatment for interests relating to income already earned or about to be earned. See, e.g., United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (earned original issue discount); Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006) (lump sum payment for annual installments of lottery prize); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (right to declared dividend).

On the other hand, as the courts have noted, "Simply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income." Guggenheim v. Commissioner, 46 T.C. 559, 569 (1966). In Guggenheim, the court focused on whether the taxpayer transferred substantial investment risks in the sale of undivided interests in a stallion. Id. There, the court noted that if the value of the stallion subsequently increased, the taxpayer would not share in that increase with regard to the interests transferred. Id. Instead, the new owners received all the benefits of an increase in value of the stallion, and all the burdens of a decrease in value. Id. Thus, the court found that the taxpayer had transferred substantial investment risks and was entitled to capital gain treatment on the sale of the interests. Id.

In United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963), the court distinguished between proceeds from the present sale of the future right to earn income, which is capital gain, and the present sale of the future right to earned income, which is ordinary income. Id. at 59. There, the court found that the sale of an income-producing asset was not merely the sale of the right to income already earned; instead, the taxpayer had an asset that would produce income in the future. Id. Thus, the court held that the taxpayer's sale of the asset generated capital gain. Id. Similarly, in Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), the court held that the taxpayer's surrender of a lease of a play constituted the sale or exchange of a capital asset, despite the fact that receipts from the play would have been ordinary income. Ferrer, at 132. In its rejection of the government's argument against capital gain treatment, the court noted that there was no equivalence between amounts paid for the surrender of the lease and the income that would have been realized by its retention. Id. at 133.

Based on the above authorities, the proper characterization under section 1221 of the Code as to the units to be held by the Trust is that the bundle of contract rights represented by each unit is property and may be treated as a capital asset for purposes of section 1221. The most important characteristic of the unit is that significant investment risks are associated with, and included in, each unit. With respect to each unit there is an opportunity for appreciation, as well as, a risk of loss. Each unit represents a substantial investment by the Trust, and each unit has an ascertainable basis. The value of each unit is directly tied to the Endowment Fund's investment performance; poor performance will detract from the value of a unit, while performance above the payout rate set by the Board will increase the value of each unit. The opportunity for appreciation, risk of loss, and basis in each unit are characteristics similar to other contract rights that are treated as capital assets (for example, other financial derivatives, mutual fund shares, or corporate stock). Further, the benefits and burdens associated with each unit are similar to those associated with property held to be capital assets in Guggenheim, Dresser, and Ferrer.

In addition, although the Trust will receive ordinary income in the form of the periodic payouts that are based in part upon the number of units owned by the Trust, consideration received upon a redemption of a unit is not a substitute for what would otherwise be received as an ordinary income payout, whether due and payable, or about to be due and payable, to the Trust under the terms of the contract. Rather, the amount paid for a unit upon a redemption is equal to the value of the unit on the date of redemption. Unit value on any given date is equal to overall asset value of the Endowment Fund divided by the number of units outstanding. Also, the unit is not an interest related to compensation for past or future personal services. Instead, the unit is an asset that will produce income in the future.

Finally, the unit does not represent a carve-out of a larger estate retained by the Trust. The appreciation of each unit is attributable to overall Endowment Fund property appreciation, much of which, in turn, is attributable to increases in the value of capital assets in the Endowment Fund. The contract provides specifically that the Trust does not have any ownership interest or rights to the Endowment Fund. Thus, the unit does not represent an interest carved out of an interest retained by the Trust.

We conclude that the unit is a capital asset for purposes of section 1221 of the Code. Furthermore, section 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of the unit as gain or loss from the sale of a capital asset. Thus, in general, the redemption of the unit by the Trust will generate short-term or long-term capital gain or loss to the Trust, depending on the holding period of the unit.

Conclusion:

Accordingly, based on the information submitted in your ruling request, we rule as follows:

1. The issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to these units, and the holding or redemption of these units will not generate unrelated business taxable income to the Board.

2. The issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to these units, the participation of the Trust in Fund A and Endowment Fund, including the payment of fees and expenses to Management Corp., and the holding or redemption of these units will not generate unrelated business taxable income to Management Corp.

3. The issuance of Endowment Fund units by the Board to Trust, the making or receipt of payments with respect to these units, and the holding or redemption of these units will not generate unrelated business taxable income to the Trust.

4. The redemption of Endowment Fund units by Trust will be treated as long- or short-term capital gain or loss, depending upon the holding period of these units.

This letter supersedes our letter ruling dated January 23, 2009, in which we erroneously described the University System as recognized under section 501(c)(3) of the Code rather than as a governmental unit under section 170(c)(1).

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

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 resolved 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,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437