



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:

Legend:

M =

P =

I =

V =

Dear

We have considered your letters dated September 16, 2009, and March 23, 2010, in which you request rulings regarding the application of sections 512 and 513 of the Internal Revenue Code (the "Code") to the transactions described below.

Facts

M is exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3). For purposes of foundation classification, M is classified as an educational organization under sections 509(a)(1) and 170(b)(1)(A)(ii).

M is the trustee and a charitable remainder beneficiary of a number of charitable remainder trusts, including I. I is a charitable remainder unitrust within the meaning of section 664(d)(2) of the Code. Under the terms of the trust agreement, I is to terminate at the death of the survivor of the donors, at which time the trustee is to distribute 25 percent of the principal and income to M and 75 percent of the principal and income to P. P is a coordinating and support organization for several independent colleges located in the city of V, including M. P is exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3). For purposes of foundation classification, P is classified as a supporting organization under section 509(a)(3). The donors reserve during lifetime the power to remove any distributee organization other than M and add one or more distributee organizations, and to

change the proportional interests of the distributee organizations at any time except that the share for M shall not be reduced below 25 percent. Any additional or replacement distributee organization must be an organization offering undergraduate or graduate instruction, located in the city of V, and described in sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Code.

M manages, maintains, and invests pooled investment funds for itself, its programs, and its departments (the "Endowment"). The Endowment is invested in a diverse manner, and includes substantial investments in public equities, bonds, private equity, and real estate. Real estate and certain other venture capital investments are undertaken primarily through partnerships. Much of the income earned by the Endowment 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.

The Endowment is delineated in one class of units of equal value ("Endowment Units"). The value of each Endowment Unit is based on the value of the underlying investments. M sets the value of an Endowment Unit on a monthly basis. Endowment Units are assigned to endowed funds (each, a "Fund") which support M's programs and departments. Each year, M determines a spending rate based, in part, on the Endowment's investment performance. M makes distributions to each Fund equal to the spending rate times the number of Units assigned to the Fund.

M wishes to give I the ability to invest in contractual rights so as to partake of the benefits and effects from investment transactions made by the Endowment. To that end, M, in its capacity as owner of the Endowment, will enter into a Contract Unit Agreement with itself, in its capacity as trustee of I, that would allow I to purchase Contract Units from M with trust assets. The purchase price of each Contract Unit would be an amount in cash equal to the value of one Endowment Unit, determined by M as of the monthly valuation of Endowment Units immediately preceding the purchase date. Monthly, M will distribute to I an amount (the "Contract Payment") calculated by multiplying the number of Contract Units held by I by the Endowment spending rate then in effect.

I may redeem Contract Units from M. The redemption price for each Contract Unit would be an amount equal to the value of one Endowment Unit, determined by M as of the normally-scheduled monthly valuation of Endowment Units immediately preceding the redemption date.

I will treat Contract Payments as ordinary income, regardless of the character of the underlying income of the Endowment, whether capital gain, ordinary income, or return of capital. I will treat redemptions of Contract Units as generating long- or short-term capital gain (or loss) depending on the holding period of the redeemed Unit.

The Contract Unit Agreement would give I neither an ownership interest in the underlying assets of the Endowment nor any contract rights with respect to any other trust that holds Contract Units. I would have no power or right 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 calculation of Contract Payments as well as the calculation of purchase and redemption prices on Contract Units held by I. I would not have the right to veto or opt out

of any of the underlying Endowment investments. With respect to the issuance of Contract Units, the Contract Unit Agreement would provide that M is neither a partner nor an agent of T, that T would never be or become liable for any cost, expense, or payment relating to the Endowment or the underlying assets incurred or due by M or for which M is liable or responsible, and that M would indemnify T and hold the T harmless from and against any liability asserted against T arising out of any action or inaction by M with respect to the Endowment or the underlying assets. The costs of managing the Endowment, Endowment Units, and Contract Units would be borne by the Endowment, and the distributions on, or redemptions of, the Contract Units held by T would reflect those costs.

Ruling Requested

M's issuance of Contract Units to T, the making or receipt of payments with respect to the Contract Units, and the holding or redemption of the Contract Units will not generate unrelated business taxable income (as defined in section 512 of the Code) to M or to T.

Law

Section 511 of the Code imposes a tax for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization that is exempt from taxation by reason of section 501(a).

In the case of a charitable remainder annuity trust or a charitable remainder unitrust which has unrelated business taxable income (within the meaning of section 512 of the Code, determined as if part III of subchapter F applied to such trust) for a taxable year, section 664(c)(2) imposes on such trust or unitrust an excise tax equal to the amount of such unrelated business taxable income.

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

Section 512(b)(1) of the Code excludes from "unrelated business taxable income" all dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.

Section 1.512(b)-1(a)(1) of the Income Tax Regulations (the "regulations") provides that dividends, interest, and other substantially similar income from ordinary and routine investments, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income.

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 an organization for income or funds or the use it makes of the profits derived) to the exercise or

performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

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(d)(1) of the regulations provides that gross income derives from "unrelated trade or business" 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.

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 causal relationship to the achievement of exempt purposes (other than through the production of income), and it is "substantially related," for purposes of section 513, 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, concerns 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 ruling 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. Consequently, the organization described in the ruling is not exempt under section 501(c)(3).

Analysis

(a) As to M

Under the reasoning of Rev. Rul. 69-528, 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 within the meaning of section 513(a). Thus, if M 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, such activities could result in unrelated business taxable income within the meaning of section 512(a)(1). Here, however, M is not charging I a fee for its services and not otherwise receiving income from the services it provides to I. Thus, under these circumstances, M will not receive unrelated business taxable income within the meaning of section 512(a)(1).

The fact that M will engage in the investment activity for the benefit of individuals who are co-beneficiaries of I 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.

(b) As to I

The investment of I's assets in Contract Units would be an investment activity, and the receipt of Contract Payments with respect to those Units would be income from ordinary and routine investments of the type that is excludible from unrelated business taxable income by reason of section 512(b)(1) of the Code and section 1.512(b)-1(a)(1) of the regulations. Thus, neither the Contract Payments nor the holding or redemption of the Units themselves would result in the receipt of unrelated business taxable income by I. For although some of the Endowment's other investments might consist of debt-financed property that generates unrelated business income, no portion of such income would be attributed or assigned to I merely because I's assets are invested in Contract Units.

The holding of a Contract Unit does not give I beneficial ownership in the Endowment. Rather, a Contract Unit represents a mere contractual right to receive Contract Payments as determined by M. Furthermore, the commingling of I's assets with other property in the Endowment for investment purposes cannot be characterized as a partnership for federal income tax purposes. M and I do not hold themselves out as partners, and show no intention to join together in the present conduct of an enterprise. On the contrary, the Contract Unit Agreement will specifically state that M is not a partner or an agent of I with respect to the issuance and holding of Contract Units. Furthermore, the proposed arrangement between M and I has none of the characteristics that are commonly associated with a partnership. The commingling of I's assets with other assets in the Endowment does not give I a capital interest in the Endowment or any other ownership interest or rights in the other assets in the Endowment. An investment in Contract Units does not give I any power or right to control, direct, supervise, recommend, or review M's business activities, operations, or decisions with respect to the Endowment, nor does it give I a right to veto or opt out of any underlying investment in the Endowment. Likewise, an investment in Contract Units does not give I a proprietor's interest in the profits and losses of the Endowment, but only a right to Contract Payments. Since the relationship between M and I is not in the nature of a partnership or agency, the Contract Payments reflect ordinary income and do not take on the character of the income of the underlying assets. M would pay any tax owed on the unrelated business taxable income earned by the Endowment, with no deduction taken against unrelated business taxable income for any payments made to I.

Conclusion

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

Income derived by either M or I from the issuance of Contract Units, the making or receipt of payments with respect to Contract Units, or the holding or redemption of Contract Units will not constitute unrelated business taxable income within the meaning of section 512 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 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,

Manager, Exempt Organizations
Technical Group

Enclosure
Notice 437