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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Date: December 1, 2011

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Uniform Issue List:
512.00-00; 1221.00-00

Legend:

M =
T =

Dear :

This is in response to your letter dated December 23, 2008, in which you request rulings regarding the application of the unrelated business income tax provisions of part III, subchapter F, chapter 1, and the capital gains and losses provisions of subchapter P, chapter 1 of the Internal Revenue Code (the "Code") to the transactions described below.

FACTS

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

M is the trustee and charitable remainder beneficiary of a number of charitable remainder trusts. Most of these trusts designate M as the sole charitable remainder beneficiary, but some of the trusts have charitable remainder co-beneficiaries in addition to M. The trusts that have charitable remainder co-beneficiaries all designate M as the "primary remainder beneficiary," which you define as a beneficiary having a remainder interest equal to, or greater than, the remainder interest of any other designated charitable remainder beneficiary of the trust.

T, a charitable remainder unitrust within the meaning of section 664(d)(2) of the Code, is one of the trusts of which M serves as trustee. T has two charitable remainder co-beneficiaries: M and an educational organization unrelated to M. Under the terms of T's

trust agreement, at the termination of the Unitrust Period, the trustee shall distribute 50 percent of the trust property to M and 50 percent of the trust property to the other charitable remainder co-beneficiary.

M owns an endowment fund that is widely diversified and invested in broad classes of assets including, cash, cash equivalents, domestic and foreign public equity securities, domestic and foreign bonds and other fixed income securities, mutual funds, private equity securities, real estate, emerging markets, and various other alternative investment classes. Most of the income earned by the endowment fund consists of passive income such as interest, dividend, and capital gain income, but some income may be debt-financed or otherwise treated as unrelated business taxable income under section 512 of the Code.

M would like to invest T's assets so that T may benefit from the diversified and efficient manner in which M's endowment fund is invested and, thereby, earn a return on investment equal to that realized by the endowment fund. To that end, M proposes to unitize the endowment fund so that the value of a unit could be determined at any given time. The value of a unit at any given time would equal the net value of the endowment fund divided by the number of units outstanding at such time. T would then be permitted to enter into a contract with M under which T would be assigned units in the endowment fund in exchange for its assets. The number of units assigned to T would be determined based upon the value of a unit at the time T's assets are conveyed to M. The contract would provide that M would not reserve or exclude any part of the endowment fund earnings from the value of a unit. Trust assets conveyed to M would then be invested in the endowment fund. It is anticipated that the endowment fund will be valued, and T permitted to acquire units in the endowment fund, monthly. The units in the endowment fund would have the same value for all trust accounting purposes.

M pays out a percentage of its endowment fund each year to fund its annual operations. The pay-out rate is determined each year based on the investment performance of the endowment fund and M's operating requirements. The contract between M and T would provide that T is entitled to receive its proportionate share of a distribution (an "endowment fund payment") based on the number of units assigned to T and the total number of units outstanding at the time of the distribution. In lieu of receiving its endowment fund payment in the form of cash, T may elect to invest the payment in additional units. Any income realized by the endowment fund but not paid out as part of the annual distribution, and any unrealized appreciation or depreciation in the endowment fund itself, would be reflected in the value of the outstanding units. T would be permitted to surrender or redeem a unit in exchange for the value of the unit at the time of redemption.

The contract between M and T would provide that T has no say in the management or

administration of the endowment fund. Accordingly, T would have no reserved power or right to control, direct, supervise, review, or make recommendations regarding M's management or administration of the endowment fund or the decisions made by M in connection with the endowment fund. Likewise, T would have no say in the determination of the endowment fund pay-out each year. T would have the right only to review the pay-out computations to verify that it has received the correct endowment fund payment.

Furthermore, the contract between M and T would provide that the T has no interest in the underlying assets or investments that make up the endowment fund, and has no right to opt out of, or veto, any underlying investment. The contract would also provide that, with respect to the issuance of units in the endowment fund, M is neither a partner nor an agent of T; that T would never be, or become, liable for any cost, expense, or payment incurred or due by M or for which M is liable relating to the endowment fund or to the underlying fund assets; and that M would indemnify and hold T harmless from and against any liability arising out of any action or inaction by M with respect to the endowment fund or its underlying assets. Finally, the contract would provide that T has no contract rights with respect to any other trust holding units in the endowment fund.

M would not charge a fee for managing and administering its endowment fund. M may, however, as trustee of T, elect to charge T a reasonable and appropriate trustee fee for services rendered as trustee. Furthermore, M may engage, or contract with, various money managers to manage the assets of its endowment fund, and may incur other direct expenses, such as accounting, bookkeeping, and legal fees, in connection with the administration of the endowment fund. The fees charged by money managers and the other administrative expenses incurred by the endowment fund will be paid as general administration expenses of the endowment fund. Likewise, any unrelated business income taxes generated by the investments of the endowment fund will be paid by the endowment fund itself, thereby reducing the value of each unit. M would not claim any deduction against its unrelated business income tax liability for payments made to T.

RULINGS REQUESTED

T has requested the following rulings:

1. The issuance of units in M's endowment fund to T, the making of endowment fund payments to T, the receipt of endowment fund payments by T, and the holding or redemption of units in the endowment fund by T, will not generate unrelated business taxable income to M or to T.

2. The units in M's endowment fund constitute capital assets, and, therefore, the

redemption of a unit by T will generate short-term or long-term capital gain or loss to T depending upon the period of time the unit was held by T.

ISSUE 1

Whether the issuance of units in M's endowment fund to T, the making of endowment fund payments to T, the receipt of endowment fund payments by T, or the holding or redemption of units by T, will generate unrelated business taxable income to M or to T.

Law

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

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 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)(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 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, unless one of the specific exceptions to section 512 or 513 is applicable, 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 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. The ruling holds that the organization is not exempt under section 501(c)(3).

Analysis

(a) As to M:

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, would be "regularly carried on" within the meaning of sections 512(a)(1) and 1.513-1(c). 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, these activities could result in unrelated business taxable income under section 512(a)(1).

Here, however, M is not charging a fee for services and not otherwise receiving income from the services provided to T. Given that M will not derive a profit from the activity, the activity is not a trade or business for purposes of section 513. Also, to the extent that M will provide the services for its own benefit as a remainder beneficiary, the activity may be distinguished from a commercial venture. Thus, under these circumstances, M will not receive unrelated business taxable income under section 512(a)(1).

(b) As to T:

The investment of T's assets in units would be an investment activity, and the receipt of endowment fund 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 endowment fund payments nor the holding or redemption of the units themselves would result in the receipt of unrelated business taxable income by T. For although some of the endowment's other investments might generate unrelated business taxable income, no portion of such income would be attributed or assigned to T merely because T's assets are invested in units.

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

Conclusion

The issuance of units in M's endowment fund to T, the making of endowment fund payments to T, the receipt of endowment fund payments by T, and the holding or redemption of units in the endowment fund by T, as described above, will not generate unrelated business taxable income to M or to T.

ISSUE 2:

Whether the units in M's endowment fund constitute capital assets, such that the redemption of a unit by T would generate short-term or long-term capital gain or loss to T depending upon the period of time the unit was held by T.

Law

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. Those exceptions are: (1) inventory; (2) property of a character that is subject to the allowance for depreciation provided in section 167 of the Code, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of 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.

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., Comm'r 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. Comm'r, 313 U.S. 28 (1958) (denying capital gain treatment

on the disposition of a term of years carved out from a fee simple).

The Court also has 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, 365 U.S. at 265.

Consistent with the "substitute-for-ordinary-income" doctrine, the 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. Comm'r, 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. Comm'r, 437 F.3d 399 (3d Cir. 2006) (lump sum payment for annual installments of lottery prize); Rhodes' Estate v. Comm'r, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

On the other hand, the courts have noted that, "[s]imply 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. Comm'r, 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. 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.

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. 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. Id.

Similarly, in Comm'r 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.

Analysis

None of the exceptions listed in section 1221 of the Code applies to a unit of M's endowment. With respect to the proper characterization of a unit under section 1221, the bundle of contract rights represented by each unit is property, and may be treated as a capital asset. The most important characteristic of a 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 T, and each unit has an ascertainable basis. The value of each unit is directly tied to the endowment's investment performance; poor performance will detract from the value of a unit, while performance above the payout rate set by M will increase the value of each unit. The opportunity for appreciation, risk of loss, and basis in each unit are characteristics similar to the 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 the property held to be capital assets in Guggenheim, Dresser, and Ferrer, supra.

In addition, T will receive ordinary income in the form of the annual payouts that are based in part upon the number of units owned by T, 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 T under the terms of the contract. Rather, the amount paid for a unit upon redemption is equal to the value of the unit on the date of the endowment divided by the number of units outstanding. In addition, 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 T. The appreciation of each unit is attributable to overall endowment property appreciation, much of which, in turn, is attributable to increases in the value of capital assets in the

endowment. The contract provides specifically that T does not have any ownership interest or rights to the endowment.

Conclusion

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

RULINGS

In view of the foregoing, we rule as follows:

1. The issuance of units in M's endowment fund to T, the making of endowment fund payments to T, the receipt of endowment fund payments by T, and the holding or redemption of units in the endowment fund by T, as described above, will not generate unrelated business taxable income (within the meaning of section 512(a)(1) of the Code) to M or to T.

2. A unit of M's endowment fund is a capital asset for purposes of section 1221 of the Code, and the redemption of a unit by T will generate short-term or long-term capital gain or loss to T, depending on the holding period of the unit.

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. You have not asked us, and we are not ruling, whether your trustee fees (or any part of them) are gross income from an unrelated trade or business.

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,

Theodore R. Lieber
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437