



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:

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Employer Identification Number:

Dear _____ :

This is in response to your request for a ruling that certain proposed contractual agreements you have with charitable remainder trusts (the "Trusts") will not generate unrelated business taxable income to you under I.R.C. § 512(a)(1).

You are exempt under I.R.C. § 501(a) as an organization described in I.R.C. § 501(c)(3) and have been classified as an educational organization under I.R.C. § 509(a)(1) and I.R.C. § 170(b)(1)(A)(ii).

You are the trustee of 145 Trusts and, as trustee, you are the legal owner of the Trusts' assets. You do not assess a trustee's fee or any other fee for the administrative services you provide to the Trusts. In addition, you have a sole charitable remainder interest in 140 of 145 of the Trusts.

As a result of the relationship with the Trusts as both trustee and beneficiary, you have a substantial interest in the value of each Trust. Moreover, the donors to the Trusts have funded the Trusts with the intention that you benefit substantially from the remainder value of the Trusts, and that the Trusts' assets will be managed to achieve the greatest possible return on investment.

Your endowment is invested in a diversified manner with investments in nontraditional assets such as private equity, real estate and natural resources and other marketable alternatives as well as more standard asset classes including U.S. and international stocks and bonds. Real estate assets and certain other alternative investments are undertaken primarily through partnership structures. Much of the income earned by the endowment consists of passive income including dividends, interest and long and short-term capital gains, but some income is debt-financed or otherwise is treated as unrelated business taxable income.

You propose to create a contractual obligation, pursuant to which you would issue a contract right to each of the Trusts for a proportionate share, or "unit", of your endowment. The value of the units would equal the value of the endowment units held by your various restricted and unrestricted funds. The contract right would entitle the Trusts to receive periodic payments based on the number of units owned. The Trusts would thereby be able to receive an investment return equal to that of the endowment.

You determine a distribution rate on the endowment each year based in part on the endowment's investment performance. You calculate the market value of each endowment unit on a monthly basis. The market value of each endowment unit initially equals the total value of the endowment investments divided by the number of outstanding units and is subsequently adjusted in accordance with the market value of the endowment. Each fund is entitled to an amount equal to the distribution rate multiplied by the number of units it holds.

You seek to enable the Trusts to invest in the endowment in a manner identical to your restricted and unrestricted funds. A Trust would acquire a unit in the endowment which would give it a contractual right against you, but no interest whatsoever in the underlying investment assets of the endowment. The contract between the Trusts and you would provide that the price of the units would equal their value at the time of acquisition. The units would have the same value that you use for internal accounting purposes. You will not charge a fee for internal management costs of the Trusts' assets, although you may recover your actual costs of management of the endowment as a charge against total return.

The contract would provide that each Trust would receive payments on the units held by it based on the distribution rate you establish for the endowment, with payouts made monthly. A Trust could choose either to reinvest part of the payout, or redeem additional units, depending on its cash requirements. The Trusts will treat payouts as ordinary income, regardless of the character of the underlying income of the endowment, whether capital gain, ordinary income, or return of capital, and regardless of whether the payout is made entirely by distributions of income or in part by redemptions of units. The Trusts will treat redemptions of units (over and above receipt of the distribution amount) as generating long or short-term capital gain (or loss), depending on the holding period of the redeemed units.

Under the contract, a Trust would not have any ownership interest in the underlying assets of the endowment or any contract rights with respect to the other Trusts. The Trusts would have no power or right of any kind to control, direct, supervise, recommend or review your business activities, operations, or decisions with respect to the endowment, except the right to review the payout computations. They would not have the right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of units, you are neither a partner nor an agent of the Trusts, the Trusts would never be liable for any cost, expense, or payment incurred by you or for which you are liable or responsible relating to the endowment (or the underlying endowment assets), and you would indemnify and hold the Trusts harmless from and against any liability arising out of any action or inaction by you with respect to the endowment (or the underlying endowment assets).

You have requested the following ruling:

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

Section 6.14 of Rev. Proc. 2011-4 provides that the Service will not issue letter rulings pertaining to unrelated business income tax issues arising when charitable lead trust assets are invested with charitable organizations. Thus, the word "Trusts" as used in this letter refers only to your charitable remainder trusts, and the ruling issued by this letter relates only to the participation by your charitable remainder trusts in your endowment.

LAW

I.R.C. § 511, in part, imposes a tax on the unrelated business taxable income of organizations described in I.R.C. § 501(c)(3).

I.R.C. § 512(a)(1) 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 I.R.C. § 512(b).

I.R.C. § 512(b) sets forth so-called "modifications," which are excluded from the computation of unrelated business taxable income. These modifications include dividends, interest, royalties, rent from real property and gain from the sale of property.

I.R.C. § 513(a) 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.

I.R.C. § 513(c) 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.

Treas. Reg. § 1.513-1(a) provides that gross income of an exempt organization subject to the tax imposed by I.R.C. § 511 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.

Treas. Reg. § 1.513-1(b) provides that for purposes of I.R.C. § 513 the term "trade or business" has the same meaning it has in I.R.C. § 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Treas. Reg. § 1.513-1(c)(1) 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 I.R.C. § 512, 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.

Treas. Reg. § 1.513-1(d)(1) provides that, in general, gross income derives from "unrelated trade or business," within the meaning of I.R.C. § 513(a), 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.

Treas. Reg. § 1.513-1(d)(2) 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 I.R.C. § 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, describes an organization that was formed to provide investment services on a fee basis exclusively to organizations exempt under I.R.C. § 501(c)(3). It receives funds from the participating exempt organizations, invests in common stocks, reinvests income and realized appreciation and, upon request, liquidates a participant's interest and distributes the proceeds to the participant. The Rev. Rul. states that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. If the services were regularly provided by one tax-exempt organization for other tax-exempt organizations, such activity would constitute unrelated trade or business. The Rev. Rul. holds that the organization is not exempt under I.R.C. § 501(c)(3).

As noted previously, organizations described in I.R.C. § 501(c)(3) are subject to tax on their unrelated business income under I.R.C. § 511. In order for such an organization's income to be subject to the unrelated business income tax, three requirements must be met: (1) the income must be from a trade or business; (2) the trade or business must be regularly carried on; and (3) the conduct of the trade or business must not be substantially related to the organization's exempt purpose or function. See Treas. Reg. § 1.513-1(a).

ANALYSIS

You propose to enter into a contractual relationship with certain Trusts that are charitable remainder trusts in which you have an interest as a beneficiary and serve as trustee of the Trusts. Under such a contractual relationship, each Trust would receive payments on the units held by it based on the distribution rate you establish for your endowment, with payouts made monthly.

Each Trust would acquire units from your endowment, which would give the Trusts a contractual right against you, but no interest whatsoever in the underlying investment assets of the endowment. The contract between the Trusts and you would provide that the price of the units would equal their value at the time of acquisition. The units would have the same value that you use for internal accounting purposes.

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

Generally, an organization that otherwise qualifies for recognition of exemption under I.R.C. § 501(c)(3) 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 I.R.C. § 513(a). See Rev. Rul. 69-528, supra. Such an activity would constitute a "trade or business" under I.R.C. § 513(c) and Treas. Reg. § 1.513-1(b) and would be "regularly carried on" under I.R.C. § 512(a)(1) and Treas. Reg. § 1.513-1(c). Thus, if you charged a fee for investment management services provided to organizations unrelated to you or generated income from the management of the funds invested by such organizations, these activities could result in unrelated business taxable income under I.R.C. § 512(a)(1). Here, however, you are not charging a fee for services and not otherwise receiving income from the services provided to the Trusts. Thus, under these circumstances, you will not receive unrelated business taxable income under I.R.C. § 512(a)(1).

The fact that you will engage in the investment activity largely for your own benefit as the remainder beneficiary limits the scope of the service provided to "others" and distinguishes it from a commercial venture.

In view of the foregoing, we rule as follows:

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

This ruling is based on the assumption that you will not charge any fee for managing the investment of the Trusts in your endowment, and that you will not assess a trustee's fee with respect to the administration of the Trusts. You may contract with third party management firms that charge a fee and receive reimbursement of expenses for management services provided to your endowment. These fees and expenses may be charged against the aggregate return of the endowment and be reflected indirectly in the payout to the Trusts and others participating in the endowment.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

We express no opinion as to the tax consequences of the proposed transaction under any other section of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representatives. A copy of this letter should be kept in your permanent records.

This ruling is directed only to the organization that requested it. I.R.C. § 6110(k)(3) provides that it may not be used or cited by others as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437

cc: