



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201016083**

Release Date: 4/23/10

Date: January 27, 2010

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number: XXXXXX

Uniform Issue List

512.00-00

Legend:

M =

N =

O =

Dear _____ :

This is in response to N's request for a ruling that certain proposed contractual relationships will not generate unrelated business taxable income under section 512(a)(1) of the Internal Revenue Code ("Code").

FACTS:

M is tax-exempt under section 501(a) of the Code. M is described in section 501(c)(3) and classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iv).

M's exempt purpose is to promote higher education in the state in which M is located, to raise and receive funds for the support and enhancement of O, a university, and aid O in its development as a leading educational institution. M has an endowment in which are invested the assets of many individual funds created by donors to support the various academic departments and schools of O.

M also is the trustee of a number of charitable remainder trusts (individually, the "Trust" and collectively, the "Trusts"). M is the legal owner of the Trusts' assets and, in addition, the owner of the remainder interest in each Trust. N is one such charitable remainder trust in which M is trustee and remainder beneficiary.

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As both the trustee and the beneficiary of the Trusts, M has a substantial interest in the value of each Trust. The Trusts benefit M, and it is the intentions of the Trusts' donors that M manage the Trusts to attain the greatest return possible. Donors have expressed their concerns when the investment returns of the Trusts have been lower than the return on M's endowment.

M invests its endowment funds in a widely diverse manner, including substantial investments in public equities, bonds, private equity, and real estate. Much of the income earned by the investment portfolio consists of dividends, interest, rents, and long- and short-term capital gains. However some income is debt-financed or otherwise unrelated business taxable income.

M uses an "endowment share" concept internally with respect to the individual endowment funds that it holds. Under this concept, each individual endowment fund owns a certain number of shares of M's endowment, with the value of each share based on the underlying endowment investments.

M would like to achieve greater economies of scale in the management of the Trusts, a potentially higher investment return for the Trusts, and increased diversification of the Trusts' investments. M seeks to create a contractual relationship with each Trust ("Contract"). Each Trust would own a contractual right against M; however, a Trust would have no interest at all in M's underlying endowment investments assets. Under the Contract between M and each Trust, the value of each of a Trust's shares would equal its value at the time of acquisition, and further, equal the value of each of the shares of M's individual endowment funds, thereby allowing the Trusts to receive investment returns equal to those of the individual endowment funds.

Under the Contract, the Trusts will have no ownership interest in M's underlying assets; no contract rights with respect to other Trusts; and no power or right of any kind to control, direct, supervise, recommend or review M's business activities, operations or decisions with respect to M's endowment, except the right to review payout computations. The Trusts will not have the right to veto or opt out of any of the underlying investments of M's endowment. Under the Contract, M will be neither a partner nor an agent of the Trusts, and the Trusts will never be liable for any cost, expense, or payment incurred or due by M or for which M is liable or responsible relating to M's endowment (or underlying endowment assets). Further, M will indemnify and hold the Trusts harmless from and against any liability arising out of any action or inaction by M with respect to M's endowment (or the underlying endowment assets). M's endowment will bear the costs of its management, and the value of the shares held by the Trust will reflect those costs. However, M will not charge a fee for its services and not otherwise receive income from the services it provides to the Trusts. Other than entities affiliated with the O, M does not manage funds for any third parties. M will pay any tax owed on unrelated business taxable income earned by its endowment portfolio, with no deduction being taken against unrelated business taxable income for any payments made to the Trusts.

RULING REQUESTED:

N has requested the following ruling:

The issuance of shares of M's endowment, pursuant to a contractual obligation, to the Trusts,

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the making or receipt of payments with respect to the shares, and the holding or redemption of the shares, all pursuant to a contract agreement, will not generate unrelated business taxable income to N under section 512(a)(1) of the Code.

LAW:

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

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 sets forth certain modifications. Under these modifications, dividends, interest, royalties, rent from real property, and gain from the sale of property are excluded from the computation of 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 an 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 Income Tax Regulations ("Regulations") provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 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 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. 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.

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ANALYSIS:

M proposes to enter into a contractual relationship with certain Trusts that are charitable remainder trusts. In all of these Trusts, M has an interest as a beneficiary and serves as trustee.

Each Trust would acquire contractual participation shares referenced to M's endowment, which would give the Trust a contractual right against M but no interest whatsoever in the underlying investment assets of M's endowment. The contract between M and each of the Trusts would provide that the price of each share would equal its value at the time of acquisition, and each share would have the same value that M uses for internal accounting purposes for its endowment funds.

The Trusts will not have a position of ownership in the underlying assets of M's endowment. Since the contractual relationship between M and the Trusts is not in the nature of a partnership or agency, the income earned by the Trusts from the payout M establishes for the units reflects ordinary income and does not take on the character of the income of the underlying assets or debt-financed or unrelated business taxable income. M will 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 Trusts.

RULING:

Based on the information submitted, we rule as follows:

The issuance of shares of M's endowment, pursuant to a contractual obligation, to the Trusts, the making or receipt of payments with respect to the shares, and the holding or redemption of the shares, all pursuant to a contractual agreement, will not generate unrelated business taxable income to N under section 512(a)(1) of the Code.

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 N's authorized representatives. A copy of this letter should be kept in N's permanent records.

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 will be made available for public inspection under section 6110 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

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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.

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,

Robert W. Malone
Acting Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437



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Sincerely,

Robert W. Malone
Acting Manager, Exempt Organizations
Technical Group 3

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Notice 437