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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

SE:T:EO:RA:T:3

UIL: 512.00-00

Legend:
University =
Trust =

Dear :

We have considered your ruling request dated April 18, 2008, concerning the federal income tax consequences under section 512 of the Internal Revenue Code of 1986, as amended (hereafter "Code"), relating to a proposed contractual arrangement in the manner and for the purposes described below.

Facts:

University is an educational institution recognized as a tax-exempt organization under sections 501(c)(3) and 170(b)(1)(A)(ii) of the Code. University maintains an endowment fund, comprised of privately raised endowments, which fund was established to provide economic resources to University to provide for its educational activities. The 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 the 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.

University 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 the trust agreement, Trust's donors are the income beneficiaries 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 University upon the death of donors. Presently, Trust assets are managed by various investment

managers in accordance with a strategy developed by an outside for-profit advisor. University represents that as trustee and remainder beneficiary, it desires to achieve increased diversification and higher and more stable investment returns "for maximum long-term benefit to support its research activities and the education of future [University] students in perpetuity." Therefore, in an attempt to accomplish these goals, University proposes to take advantage of the concept of economies of scale, by allowing Trust to commingle its assets with those of University's endowment fund. A higher rate of return on Trust's assets would cause its donors to receive a higher unitrust payout, and would cause University to ultimately receive a higher final payment as the remainder beneficiary.

University proposes to enable Trust to participate in University's endowment fund through the acquisition of "shares." University proposes to create a contractual obligation, pursuant to which it will issue to Trust a contract right, called shares, in its endowment fund in exchange for Trust investing its assets in the endowment fund. University represents that the number of shares Trust will receive will be in proportion to the value of Trust's investment in University's endowment fund. The contract will provide that Trust will receive an income payout based on the number of shares owned and the annual endowment fund spending rate, which rate is determined by University. The value of the shares, 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 shares, 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. Redemptions of shares 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 shares. Furthermore, University will pay any tax owed on unrelated business taxable income earned by its endowment fund.

University 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 University'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 endowment investments. The contract would provide that, with respect to the issuance of shares, University is neither a partner nor an agent of Trust. Trust would also never be or become liable for any cost, expense, or payment incurred or due by University or for which University is liable or responsible relating to the endowment (or the underlying endowment assets), and University would indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by University with respect to the endowment fund (or the underlying assets).

As to the issue of fees and cost, the University states that it "will not charge any fee for management of the [Trust] assets, although it may recover its actual costs of management of the [endowment fund], as a charge against total investment return. In addition, it may recover the actual costs of administration of the [Trust] as a charge against the [Trust]."

You have requested the following ruling:

The issuance of endowment fund shares by University to Trust, the making or receipt of

payments with respect to the shares, and the holding or redemption of shares will not generate unrelated business taxable income to University or Trust.

Law:

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 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 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 1.512(b)-1(a)(1) of the Income Tax Regulations ("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 all deductions directly connected with any of the foregoing items of 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.

Analysis:

The issue is whether University and Trust will each incur unrelated business taxable income upon the issuance of University's endowment fund shares to Trust, upon the making or receipt of payments with respect to the shares, and upon the holding or redemption of the shares.

Section 511 of the Code imposes a tax on the income earned by an organization

described in section 501(c)(3), if the income results from the operation of the organization's unrelated trade or business. An organization described in section 501(c)(3) that provides services 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).

The proposed contractual relationship between University and Trust is not a trade or business that will generate income for University, and therefore it does not meet the first condition for a finding of unrelated business income. University represents that it will not earn any income from the proposed contractual relationship with Trust. Rather, University will only be recovering its actual costs of managing its endowment fund and its actual costs of administrating Trust. Furthermore, the relationship between University and Trust is not of a commercial nature such as that of a trade or business. University represents that it is both the trustee and remainder beneficiary of Trust's assets. As such, University will be engaging in investment activity of Trust assets partially on its own behalf. University represents that Trust neither has any ownership interest in the underlying assets of the endowment fund, nor does it have a right to control University's decisions as to the endowment fund, and that Trust will not be responsible for any liability relating to the endowment. Although Trust's donors, who are the present income beneficiaries for life, may also benefit from the diversification and increased rate of return by commingling Trust's assets with those of University's endowment fund, the unique relationship between University and Trust distinguishes it from a trade or business. This relationship 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 University is not charging any fees for investing in its endowment fund and because University is investing funds on its own behalf as sole remainder beneficiary and as trustee, Rev. Rul. 69-258 is not applicable. Therefore, because the services University provides to Trust are not a trade or business that will generate income, University does not meet the first condition listed above for a finding of unrelated business income.

As for the issue of whether Trust will incur unrelated business taxable income upon the proposed transaction with University, the answer is dependent in part on whether the income earned by Trust is passive income and subject to the unrelated business taxable income exception under section 512(b) of the Code. As stated above, section 511 of the Code imposes a tax on an organization's unrelated trade or business income if three conditions are met, the first of which is that the organization engages in a trade or business that generates income. See Section 1.513-1(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). However, under sections 512(b) of the Code and 1.512(b)-1 of the regulations, investment income is excluded in computing unrelated business taxable income if the income results from "[d]ividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulations 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..."

Here, the income that Trust is expected to receive from commingling its assets with those of the University's endowment fund falls within the exception for certain investment income under sections 512(b) of the Code and 1.512(b)-1 of the regulations. University represents that much of the income earned by the endowment fund consists of passive dividends, interest, rents and long- and short-term capital gains. Although University represents that some income is debt financed or otherwise is treated as unrelated business taxable income, the tax owed on such unrelated business taxable income will be paid by University's endowment fund. Because Trust is only a passive investor and only has a contractual right against University and not any interest in the underlying investment assets of the endowment fund, the unrelated business taxable income generated from any debt-financed property is not attributable to Trust. Specifically, the contractual arrangement between University and Trust provides that Trust will only receive an income payout based on the number of shares owned in the endowment fund and the annual endowment fund spending rate, which payout is characterized as ordinary income to Trust (regardless of whether the underlying income to the endowment fund is characterized as capital gain or a return of capital). The redemption of shares will be treated as either long- or short-term capital gain (or loss), depending on the holding period of the units. Under the terms of the contract Trust would neither have any ownership interest in the underlying assets of the endowment fund, 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 University's business activities, operations, or decisions with respect to the endowment fund, except the right to review the payout computation. Based upon the above, Trust is purely a passive investor in University's endowment fund with the income that Trust earns from the endowment fund being substantially similar to income from ordinary and routine investments. Therefore, Trust will not incur unrelated business taxable income upon investing in University's endowment fund.

Conclusion:

Accordingly, based on the information submitted, we rule that the issuance of endowment fund shares by University to Trust, the making or receipt of payments with respect to the shares, and the holding or redemption of shares will not generate unrelated business taxable income to University or Trust.

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