



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:

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Employer Identification Number: XXXXXX

Uniform Issue List:

512.00-00

Legend:

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Dear _____ :

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

FACTS:

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

Your exempt purpose is to promote higher education in the state in which you are 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. You have 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.

You are also the trustee of a number of charitable remainder trusts (collectively, the "Trusts"). You are the legal owner of the Trusts' assets and, in addition, the owner of the remainder interest in each Trust.

As both the trustee and the beneficiary of the Trusts, you have a substantial interest in the value of each Trust. The Trusts benefit you, and it is the intentions of the Trusts' donors that you manage the Trusts to attain the greatest return possible. Donors have expressed their concerns

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when the investment returns of the Trusts have been lower than the return on your endowment.

You invest your 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. You use an "endowment share" concept internally with respect to the individual endowment funds that you hold. Under this concept, each individual endowment fund owns a certain number of shares of your endowment, with the value of each share based on the underlying endowment investments.

You 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. You seek to create a contractual relationship with each Trust ("Contract"). Each Trust would own a contractual right against you; however, a Trust would have no interest at all in your underlying endowment investments assets. Under the Contract between you and each Trust, the value of each Trust's shares would equal its value at the time of acquisition, and further, equal the value of each of the shares of your 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 your 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 your business activities, operations or decisions with respect to your 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 your endowment. Under the Contract, you 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 you or for which you are liable or responsible relating to its endowment (or underlying endowment assets). Further, you will indemnify and hold the Trusts harmless from and against any liability arising out of any action or inaction by you with respect to your endowment (or the underlying endowment assets). Your endowment will bear the costs of its management, and the value of the shares held by the Trust will reflect those costs. However, you will not charge a fee for your services and not otherwise receive income from the services you provide to the Trusts. Other than entities affiliated with O, you do not manage funds for any third parties. You will pay any tax owed on unrelated business taxable income earned by your endowment portfolio, with no deduction being taken against unrelated business taxable income for any payments made to the Trusts.

RULING REQUESTED:

You have requested the following ruling:

The issuance of shares of your 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 contract agreement, will not generate unrelated business taxable income to you under section 512(a)(1) of the Code.

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Section 6.14 of Rev. Proc. 2008-4 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:

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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Section 1.513-1(d)(1) of the regulations provides that, in general, gross income is derived 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 (1) the business activities that generate the particular income in question and (2) 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, 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 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).

In contrast, Rev. Rul. 71-529, 1971-2 C.B. 234, held that an organization was described in section 501(c)(3) of the Code where its governing documents provided that it was formed exclusively for charitable purposes, specifically, to aid organizations exempt from Federal income tax under section 501(c)(3) of the Code by assisting them to manage more effectively their endowment or investment funds, including the making of arrangements for more effective handling of their funds, and by obtaining contributions to cover all or part of the costs of the management of such funds or to provide supplemental income or capital to be used exclusively for the charitable, educational, or scientific purposes of such organizations. Most of the operating expenses of the organization, including the costs of the services of the investment counselors and the custodian banks, were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee for the services performed. These fees represented less than fifteen percent of the total costs of operation. By providing the service described above to its members, the organization was found to be performing an essential function for charitable organizations. By performing this function for the organizations

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for a charge that was substantially below cost, the organization was performing a charitable activity within the meaning of section 501(c)(3).

See also, Rev. Rul. 72-369, 1972-2 C.B. 245, in which an organization performing similar services, but at cost, was found not eligible for tax-exempt status under section 501(c)(3). The ruling states that the fact that "the services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501 (c) (3) of the Code. Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable."

ANALYSIS:

You propose to enter into a contractual relationship with certain Trusts that are charitable remainder trusts. In all of these Trusts, you have an interest as a beneficiary, and serve as trustee.

Each Trust would acquire contractual participation shares referenced to your endowment, which would give the Trust a contractual right against you but no interest at all in the underlying investment assets of the endowment. The contract between you 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 you use for internal accounting purposes for your endowment funds.

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*, and Rev. Rul. 72-369, *supra*. Such an activity would constitute a "trade or business" under section 513(c) and section 1.513-1(b) of the regulations, and would be "regularly carried on" under section 512(a)(1) and section 1.513-1(c) of the regulations. 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 section 512(a)(1). However, from the above facts, you plan not to charge the Trusts a fee for your services in managing them and will not otherwise be receiving income from the services you provide to the Trusts. Therefore, under these circumstances, you will not receive unrelated business taxable income under section 512(a)(1).

The fact that your services are provided only for your own benefit and for the benefit of charitable remainder trusts of which you are the remainder beneficiary limits the scope of the service provided to "others" and distinguishes it from a commercial venture.

RULING:

Based on the information submitted, we rule as follows:

The issuance of shares of your 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 contractual agreement, will not generate unrelated business taxable income to you under section 512(a)(1) of the Code.

This ruling is based on the following two assumptions:

1. You will not charge any fee for managing the investment of the Trusts in your endowment. Other third party management firms charge a fee and receive reimbursement of expenses for management services provided to your endowment. These fees and expenses are charged against the aggregate return of the endowment and will be reflected indirectly in the payout to the Trusts and others participating in the endowment. You will also be entitled to the fees any trustee may receive with respect to administering the Trusts.
2. You are the sole charitable beneficiary of each charitable remainder trust.

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. Section 6110(k)(3) of the Code 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,

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

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