

Internal Revenue Service

Number: **201636043**
Release Date: 9/2/2016

Index Number: 513.00-00, 513.01-00,
512.00-00, 512.04-00, 664.03-02

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:EO2
PLR-T-103432-15
Date:
May 18, 2016

Attn:

LEGEND

Charity =
Trust =

Dear _____ :

This letter responds to a letter from your authorized representative dated September 18, 2014, and subsequent correspondence, requesting a ruling that the Trust's exchange of assets for units with respect to Charity's endowment, receipt of payments with respect to the units, and the holding and redemption of units as described below will not generate unrelated business taxable income to Trust. Trust represents the facts as follows.

FACTS

Trust is a charitable remainder unitrust described in § 664(d)(2) of the Internal Revenue Code of 1986, as amended (the "Code"). Under the terms of the trust agreement, Trust's donor is entitled to an annual payout of a unitrust amount equal to a percentage of the net fair market value of Trust's assets. The remainder interest in Trust will be distributed to Charity as the remainder beneficiary.

Charity is recognized as a tax-exempt organization described in § 501(c)(3) and classified as a public charity described in §§ 509(a)(1) and 170(b)(1)(A)(vi) of the Code. Charity's primary purpose is to support a particular religious community and its religious, health, social service, and educational institutions. Charity provides financial and administrative support to approximately one hundred and fifty organizations in its region. Charity maintains an endowment through an investment partnership with other tax-exempt organizations. The investment partnership holds a widely diversified portfolio of

assets including cash, cash equivalents, domestic and foreign public equities, real estate, domestic and foreign bonds and other fixed income securities, mutual funds, private equity securities, emerging markets, and various other alternative investment classes. Much of the income earned by the endowment fund consists of passive income such as dividends, interest, and capital gains, but some income has been debt-financed or is otherwise treated as unrelated business taxable income under § 512.

Charity pays out a certain amount of its unrestricted endowment fund each year to fund its operations, creating an “unrestricted annual endowment spending rate.” This annual spending rate is determined according to the factors in the version of the Uniform Prudent Management of Institutional Funds Act enacted in Charity’s state. These include: the duration and preservation of the endowment fund, the purposes of the institution, general economic conditions, possible effects of inflation or deflation, the expected total return from investment, other resources of the institution, and the investment policy of the institution. Each year Charity’s senior managers recommend a spending rate to the Budget and Administration Committee of its Board of Directors. The Committee considers and recommends a rate to the full board which votes to adopt that year’s rate. The spending rate has historically stayed fairly consistent.

Charity will become the sole trustee of Trust prior to the exchange for assets for units. In its capacity as trustee, Charity will want Trust to benefit from its diversified and efficient investment and allow Trust to earn a return equal to that realized by endowment fund. To this end, Charity and Trust propose to enable Trust to participate indirectly in the return on Charity’s endowment by entering into an Agreement that will provide for the exchange of Trust assets for units with respect to the endowment. The number of the units assigned to Trust will be based on the value of a unit at the time Trust’s assets are conveyed to Charity. The endowment fund will be unitized so that the value of the unit can be determined at any given time. The value of a unit at any time will equal the net value of the assets in the endowment fund divided by the number of units outstanding at such time. Charity will not reserve or exclude any part of its unrestricted endowment fund earnings from the value of the units. Each unit will give Trust a contractual right to receive periodic payments based on the number of units owned multiplied by the same spending rate that Charity uses, as described above. The contract will provide that Trust can choose to either reinvest part of the periodic payments in additional units, or redeem units, depending on Trust’s cash requirements for meeting its minimum distribution. The value of the units, both at the time of acquisition and redemption, will be based on the value of all underlying investment assets. Any income realized by the endowment fund, but not paid out as part of the annual distributions, and any unrealized appreciation or depreciation in the endowment fund itself, will be reflected in the value of the outstanding units.

Under the contract, Trust will have no ownership interest in the underlying assets of the endowment or the investment partnership, and no contractual rights with respect to other trusts also invested in units with respect to the endowment. All endowment

investments will continue to be made in Charity's name, and for Charity's benefit. Except for the right to review the payout computation, Trust will have no power or right of any kind to control, direct, supervise, recommend or review Charity's business activities, operations, or decisions with respect to the endowment or the investment partnership. Trust will not have the right to veto or opt out of any of the underlying endowment investments. When Charity makes decisions regarding the endowment investments, it will not be acting in its capacity as trustee of Trust. The contract will provide that, with respect to the issuance of units, Charity is neither a partner nor an agent of Trust. Trust will not be or become liable for any cost, expense, or payment incurred or due by Charity, or for which Charity is liable or responsible relating to the endowment (or its interest in the investment partnership and its assets) other than bearing its allocable portion of the costs of management as described below. Charity will indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by Charity with respect to the endowment (or the underlying assets). Charity will pay any tax owed on unrelated business taxable income earned by the endowment's portfolio.

Charity will not assess a fee for managing and administering its endowment fund; however, it expects to recover its actual costs of managing the endowment, including the actual costs of management of Trust assets, as a charge against the total investment return of the endowment. These costs will decrease the value of Trust's units.

LAW AND ANALYSIS

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

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 § 512(b).

Section 512(b)(1) 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.

Section 512(b)(3) of the Code excludes from the definition of unrelated business taxable income certain rents.

Section 512(b)(5) excludes from the definition of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than

property held primarily for sale to customers in the ordinary course of a trade or business.

Section 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 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) 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. 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(c) of the Code provides, in part, that a charitable remainder unitrust shall, for any taxable year, not be subject to any tax imposed by Subtitle A, unless a trust has unrelated business taxable income (within the meaning of § 512 of the Code, determined as if part III of Subchapter F applied to such unitrust), in which case there is imposed on the unitrust an excise tax equal to the amount of such unrelated business taxable income.

Section 664(d)(2) 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 § 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 §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 § 170(c) or is to be retained by the trust for such a use; and (D) with respect to each contribution of property to the trust, the value (determined under § 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 of the Income Tax Regulations (“regulations”) states that whether a particular item of income falls within any of the modifications provided in § 512(b) shall be determined by all the facts and circumstance of each case.

Section 1.512(b)-1(a)(1) excludes from the computation of unrelated business taxable income: certain investment income including dividends, interest, payments with respect to securities loans (as defined in § 512(a)(5)), annuities, income from notional principal contracts (as defined in § 1.863-7 or regulations issued under § 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.

Section 1.512(b)-1(d)(1) excludes from the computation of unrelated business taxable income: certain investment income including gains or losses from the sale, exchange or other disposition of property other than (i) stock in trade or property of a kind which would be property included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of a trade or business.

Section 1.513-1(a) includes gross income of an exempt organization subject to the tax imposed by § 511 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) provides that for purposes of § 513 the term "trade or business" has the same meaning it has in § 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) 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 § 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.

Section 1.513-1(d)(1) provides that, in general, gross income derives from an "unrelated trade or business," within the meaning of § 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. This requirement necessitates an examination of the relationship between the business activities which generate the particular income in question — the activities 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) 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 § 513, only if the causal relationship is a substantial one. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends upon the facts and circumstances.

A charitable remainder unitrust described in § 664(d)(2) pays a fixed percentage of the value of its assets to an individual for a term of years or a life-time, and then transfers the remainder to or for the use of an organization described in § 170(c). Under § 664(c)(1) income from such trusts is exempt from federal income tax. However, under § 664(c)(2) an excise tax is imposed equal to the amount of any unrelated business taxable income of the trust.

For exempt organizations, including charitable remainder unitrusts, income from certain passive investments, such as interest, dividends, rent from taxation, and similarly produced passive income is generally excluded from taxation as unrelated business income by § 512(b)(1). In addition, gains from sale or exchange of property, other than property that is stock in trade or primarily held for sale to customers in the ordinary course of business are excluded from the computation of unrelated business taxable income by § 512(b)(5). Treas. Reg. § 1.512(b)-1 provides that whether the modifications of § 512 apply depends upon the facts and circumstances of each case.

In this case, Trust will not acquire any ownership interest or rights in the assets of the endowment by investing its assets in units and holding the units. An investment in units will not give Trust any power or right to control, direct, supervise, recommend, or review the business activities, operations, or decisions of Charity with respect to the endowment, nor will it give Trust the right to veto or opt out of any underlying investment in the endowment. Likewise, an investment in units will not give Trust a proprietor’s interest in the profits and losses of the endowment. Rather, a unit will represent a mere contractual right to receive periodic payments from the endowment as determined by Charity.

Furthermore, Trust’s investment in units with respect to the endowment will not be characterized as a partnership for federal income tax purposes. Charity and Trust will 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 Charity and Trust will specifically state that Charity is not a partner or an agent of Trust with respect to the issuance and holding of units. Furthermore, the proposed arrangement between Charity and Trust has none of the characteristics that are commonly associated with a partnership.

Trust’s investments in units with respect to the endowment do not give Trust any ownership interest in the underlying assets of the endowment and the relationship between Charity and Trust will not be in the nature of a partnership or agency.

Accordingly, the payments from the Charity will reflect ordinary income and not take on the character of the income of the underlying assets.

Although Trust has represented that some of the assets in the endowment are debt-financed or otherwise treated as producing unrelated business taxable income to Charity under § 512, the character of the assets in the endowment will not determine the character of Charity's payments to Trust. Trust will only have a right to the amount of income from the unit payout that Charity determines in its sole discretion under its spending policy. The payment that Trust will receive is based on a contract, not on the character or performance of the underlying assets. Therefore, any debt-financing associated with an underlying asset in the endowment is not relevant in determining whether Trust has any unrelated business taxable income.

Trust's exchange of assets for units will be an investment activity and the receipt of payments with respect to those units will be income from ordinary and routine investments of the type that is excludible from unrelated business taxable income by reason of § 512(b)(1) and § 1.512(b)-1(a)(1). Accordingly, neither the receipt of payments with respect to the units nor the holding of the units will result in the receipt of unrelated business taxable income to Trust.

In addition, the proposed contract between Trust and Charity allows Trust to redeem units and receive from Charity the value of a unit on the date Trust surrenders it to Charity. Under the facts of the contractual arrangement, units will be neither inventory nor property that is primarily held for sale to customers in the ordinary course of business. A redemption of units will fall within § 512(b)(5) and § 1.512(b)-1(d)(1) and be treated as gain or loss recognized in connection with the investment activities of Trust. Thus, money Trust will receive when it redeems units will not be characterized as unrelated business taxable income.

CONCLUSION

Based solely on the facts and representations submitted, we rule that Trust's exchange of assets for units with respect to Charity's endowment, receipt of payments with respect to the units, and holding and redeeming units will not generate unrelated business taxable income to Trust.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an individual with authority to bind the taxpayer. This office has not verified any of the material submitted in support of the request for rulings, and such material is subject to verification on examination.

No ruling is granted as to whether Charity qualifies as an organization described in § 501(c) and, except as expressly provided above, no opinion is expressed or implied

concerning the federal income tax consequences of any other aspects of any transaction or item of income set forth in the ruling letter. In particular, no opinion is expressed or implied concerning whether income or loss from a surrender or redemption of units is treated as ordinary income or loss or as gain or loss from the sale or exchange of a capital asset.

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Andrew F. Megosh, Jr.
Senior Tax Law Specialist
Branch 2
(TEGE Associate Chief Counsel)

cc: