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Person To Contact:
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Telephone Number:

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Date:
April 11, 2017

LEGEND

College =
Trust =

Dear :

This letter responds to a letter from your authorized representative dated October 26, 2016, and subsequent correspondence, requesting a ruling that Trust's purchase of investment units of College's endowment, the receipt of payments with respect to the units, and the holding and redemption of units, all as described in this ruling letter, 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.¹ College is Trust's sole charitable remainder beneficiary. College acts as the sole trustee, and in that capacity is the legal owner of the assets of the Trust. Under the terms of the trust agreement, Trust's donor and his wife are entitled to an annual payout of a unitrust amount equal to a percentage of the net fair market value of Trust's assets. Upon the death of donor and his wife, the remainder interest in Trust will be distributed to College as the remainder beneficiary.

College is an educational institution recognized as a tax-exempt organization described in §§ 501(c)(3) and 170(b)(1)(A)(ii). College's Trustee Committee on Investment, working with a consultant and investment managers, has the responsibility for managing College's pooled endowment (the "endowment"). The investment objective of the endowment is to provide a growing stream of income to support College's programs

¹ The Internal Revenue Code of 1986, as amended, to which all subsequent "section" references are made unless otherwise indicated.

while at the same time preserving the purchasing power of the endowment.

Presently, Trust's assets are managed by an outside investment firm. Trust's returns generally have been lower than the returns on College's endowment. As trustee and remainder beneficiary, College wants to achieve greater economies of scale in the management of Trust's assets, a potentially higher and more stable investment return for Trust, and increased diversification of Trust's investments. To this end, College intends to enable Trust to participate indirectly in the return on College's endowment.

In lieu of a partnership or a direct commingling, College proposes to create a contractual obligation pursuant to which College will issue a contract right to Trust for its endowment units ("units"). The value of the units, both at the time of acquisition and at the time of redemption, will be based on the value of all underlying investment assets held in the endowment. The value of each unit equals the value of the endowment divided by the number of outstanding 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 College establishes for the endowment, allowing Trust to receive an investment return equal to that of the endowment. Distributions will be made at least quarterly. Trust will be able to choose either to reinvest part of a distribution in additional units or to redeem units, depending on Trust's cash requirements for meeting its minimum distribution. Trust will treat payouts to its beneficiaries up to the endowment spending amount 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 by Trust is made entirely from distributions of income or in part from redemption of units.

The units will give Trust a contractual right to receive periodic payments from the endowment, as determined by College, but no interest whatsoever in the underlying investment assets of the endowment or with respect to other trusts also invested in units with respect to the endowment. 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 College's business activities, operations, or decisions with respect to the endowment. Trust will not have the right to veto or opt out of any of the underlying endowment investments. The proposed contract provides that, with respect to the issuance of units, College is neither a partner nor an agent of Trust. Trust will not be liable for any cost, expense, or payment incurred or due by College, or for which College is liable or responsible, relating to the endowment (or the underlying endowment assets). College will indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by College with respect to the endowment (or the underlying assets). College also will pay any tax owed on unrelated business taxable income earned by the endowment's portfolio.

While College will not charge any fee for managing Trust's assets, College may recover

its actual costs of managing the endowment as a charge against the endowment, which will decrease the value of all the endowment units, including Trust's units. College also may recover its actual costs of administering Trust as a charge against Trust.

Trust is representative of a number of charitable remainder annuity trusts and charitable remainder unitrusts with respect to which College has and will have the sole charitable remainder interest and for which College will be the trustee. College plans to make units available to these other trusts on the same terms as described in this letter for Trust, including that it will not assess a fee for the administrative services it provides to any of these trusts but may recover its costs.

LAW AND ANALYSIS

Section 664(c)(1) provides that, in general, neither a charitable remainder annuity trust nor a charitable remainder unitrust shall, for any taxable year, be subject to any tax imposed by Subtitle A of the Internal Revenue Code. However, § 664(c)(2)(A) provides that, in the case of a charitable remainder annuity trust or a charitable remainder unitrust that has unrelated business taxable income (within the meaning of § 512, determined as if §§ 511 through 515 applied to such trust) for a taxable year, an excise tax is imposed on such trust or unitrust equal to the amount of such unrelated business taxable income.

Section 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 § 512(b).

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.

Treas. Reg. § 1.513-1(a) provides that income of an exempt organization subject to the tax imposed by § 511 is included in its gross income 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 § 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.

For exempt organizations, including charitable remainder unitrusts, income from certain passive investments, such as interest, dividends, rent, 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. See § 512(b)(5). Whether the modifications of § 512 apply is dependent upon the facts and circumstances of each case. See Treas. Reg. § 1.512(b)-1.

In this case, Trust's investment in units and holding of the units will not give Trust any ownership interest or rights in the assets of the endowment. Trust will not have any power or right to control, direct, supervise, recommend, or review the business activities, operations, or decisions of College with respect to the endowment, nor can it veto or opt out of any underlying investment in the endowment. Rather, a unit represents a mere contractual right to receive periodic payments from the endowment, as determined by College.

Furthermore, Trust's investment in units will not create a partnership for federal income tax purposes. The proposed arrangement between College and Trust has none of the characteristics that are commonly associated with a partnership, and the contract between College and Trust specifically states that College is not a partner or an agent of Trust with respect to the issuance and holding of units.

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 College under § 512, each periodic payment that Trust will receive is based on a contract giving Trust the right to receive periodic payments calculated by reference to College's endowment without regard to the character or performance of the underlying assets. Therefore, any debt-financing associated with an underlying asset in College's endowment is not relevant in determining whether Trust has any unrelated business taxable income.

Trust's purchase of units will be an investment activity, and the receipt of payments with respect to those units will be income from ordinary and routine investments similar to the type that is excludible from unrelated business taxable income by § 512(b)(1) and Treas. Reg. § 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 College allows Trust to redeem units for the value of each unit on the date Trust surrenders it to College. 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 Treas. Reg. § 1.512(b)-1(d)(1); thus, money Trust will receive when it redeems units will not be taxed 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 College's endowment, receipt of payments with respect to the units, and the holding and redemption of units will not generate unrelated business taxable income to Trust.

The rulings contained in this letter are 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.

This letter does not address the applicability of any section of the Code or Regulations to the facts submitted other than with respect to the sections specifically described, 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 letter.

Because it could help resolve questions concerning federal income tax status, this letter should be kept in Trust's permanent records.

A copy of this letter must be attached to any tax return to which it is relevant. Alternatively, if Trust files a return electronically, this requirement may be satisfied by attaching a statement to the return that provides the date and control number of this letter.

This letter will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see the enclosed Notice 437, Notice of Intention to Disclose. A copy of this letter, showing the deletions that we intend to make on the version that will be made available to the public, is attached to the Notice 437. If Trust disagrees with our proposed deletions, it should follow the instructions in Notice 437.

This ruling 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 Trust's authorized representative.

Sincerely,

Mike Repass
Senior Technician Reviewer
(TEGE Associate Chief Counsel)

cc: