

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201730022**
Release Date: 7/28/2017

Third Party Communication: None
Date of Communication: Not Applicable

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

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:EO1
PLR-139753-16

Date:
April 26, 2017

School =
Trust =

Dear :

This letter responds to a letter from your authorized representative dated December 22, 2016, and subsequent correspondence, requesting a ruling that Trust's purchase of investment units of School'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 School is Trust's sole charitable remainder beneficiary. School 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 is entitled to an annual payout of a unitrust amount generally equal to a percentage of the net fair market value of Trust's assets. Upon the death of donor or a term of years, the remainder interest in Trust will be distributed to School as the remainder beneficiary for its general charitable purposes.

School is an educational institution recognized as a tax-exempt organization described in §§ 501(c)(3) and 170(b)(1)(A)(ii). School's Investment Committee has the responsibility for managing School's pooled endowment (the "endowment"), in

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

accordance with policies established by the Board of Trustees with day-to-day recording responsibilities maintained by School's business office. School seeks to invest the endowment to receive maximum long-term benefits to support the education of future School students in perpetuity.

School is concerned that it cannot deliver investment results matching those of the endowment and that Trust cannot be diversified sufficiently unless they can be commingled alongside all endowment assets. As trustee and remainder beneficiary, School 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, School intends to enable Trust to participate indirectly in the return on School's endowment.

In lieu of a partnership or a direct commingling, School proposes to create a contractual obligation pursuant to which School would issue a contract right to Trust for its endowment units ("units"). The value of the units, both at the time of acquisition and redemption, will be based on the value of all underlying investment assets held in the endowment. Each unit has a value of one dollar. The number of units is adjusted on a quarterly basis, either upwards or downwards, to reflect changes to the value of the endowment, so that the value of a unit is always set at one dollar.

Each unit will give Trust a contractual right to receive periodic payments based on the number of units owned which would adjust based on the underlying value of the endowment, allowing Trust to receive an investment return equal to that of the endowment. Trust can choose to either reinvest part of the distribution in additional units, or redeem units, depending on Trust's cash requirements for meeting its minimum distribution. Trust will treat payouts to its beneficiaries up to the endowment payout amount and any additional distributions as ordinary income, regardless of the character of the underlying income of the endowment (whether capital gain, ordinary income, or return of capital).

The units will give Trust a contractual right to receive periodic payments from the endowment, as determined by School, 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 School'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, School is neither a partner nor an agent of Trust. Trust will not be liable for any cost, expense, or payment incurred or due by School, or for which School is liable or responsible, relating to the endowment (or the underlying endowment assets). School will indemnify and hold Trust harmless from and against any liability arising out of any action or inaction by School with respect to the endowment (or the

underlying assets). School also will pay any tax owed on unrelated business taxable income earned by the endowment's portfolio.

School will not charge a fee for internal management costs of Trust assets, although it may recover its actual costs of management of the endowment as a charge against the total investment return of the endowment. These charges will decrease the value of Trust's units. School also does not assess a trustee's fee or any other charge for the administrative services it provides to Trust. However, it may recover the actual costs of administration of the 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 School has and will have the sole charitable remainder interest and for which School will be the trustee. School will 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 trustee's fee or any other charge for the administrative services it will provide as trustee of any of these trusts.

LAW AND ANALYSIS

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.

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 1.513-1(a) of the Income Tax Regulations (“regulations”) 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) of the regulations 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 a 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 School 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 School.

Furthermore, Trust’s investment in units will not create a partnership for federal income tax purposes. The proposed arrangement between School and Trust has none of the characteristics commonly associated with a partnership, and the contract between School 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 School 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 School’s endowment without regard to the character or performance of the underlying assets. Therefore, any debt-financing associated with an underlying asset in School’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 School allows Trust to redeem units for the value of each unit on the date Trust surrenders it to School. 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 School'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 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.

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 in this letter, no opinion is expressed or implied concerning the tax consequences of any aspects of any transaction or item of income discussed or referenced in this 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. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or

series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2017-1, § 11.05.

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

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

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

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

David L. Marshall
Assistant Branch Chief
Exempt Organizations Branch 1
(TEGE Associate Chief Counsel)

Enclosure