



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Telephone Number:

Uniform Issue List: 501.37-00
513.00-00
514.07-00

Legend:

M =

C =

x =

Dear _____ :

This responds to a letter from M's authorized representatives, who have requested rulings under sections 513, 514, and 501(m)(5) of the Internal Revenue Code on M's behalf.

The information provided indicates that M is a charitable organization exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). M offers gift annuities to its donors. M proposes to offer an annuity contract to C, an individual. The proposed annuity contract would establish a deferred gift annuity under which C makes a charitable contribution of \$ _____ in exchange for the obligation of M to pay an annuity to C in fixed amounts over the life of C, with the beginning date for payment deferred to some date in the future.

The annuity contract allows C to elect the commencement date of the payments under the annuity at any time during a period of eight years from the time C, who is currently age _____, reaches age _____ to the time C reaches age _____. When this election is made, the annual annuity payment will be determined based on C's age at the time payments begin--the older C is, the larger the annual annuity payments.

The value of the annuity contract varies depending on the starting date elected by C. For purposes of valuing the annuity issued in exchange for the charitable contribution by C, M will use the highest possible value of the annuity contract, \$ _____, which would be the current value of the annuity with a starting date at age _____ and an annual annuity of \$ _____, based on the

mortality tables set forth in section 7520 of the Code and section 20.2031-7 of the Estate Taxes Regulations, and the interest rates as set forth in section 7520. Since the actual starting date, and therefore the actual value of the annuity contract, will not be finally established until a later year, M and C will place the highest possible value on the annuity contract.

Rulings Requested:

The following rulings have been requested:

1. The issuance of deferred charitable gift annuities of the type described above will not result in income from an unrelated trade or business as defined in sections 511-513 of the Code.
2. The income earned by M from investment of annuity funds will not be unrelated debt-financed income under section 514 of the Code.
3. Annuity contracts issued by M as described above are charitable gift annuities as defined in section 501(m)(5) of the Code.

Law:

Section 501(m)(1) of the Code provides that an organization described in section 501(c)(3) shall be exempt from tax under section 501(a) only if no substantial part of its activities consists of providing commercial-type insurance.

Section 501(m)(2) of the Code provides that, in the case of an organization described in section 501(c)(3) which is exempt from tax under section 501(a) after application of section 501(m)(1), the activity of providing commercial-type insurance shall be treated as an unrelated trade or business as defined in section 513(a).

Section 501(m)(3)(E) of the Code provides that the term “commercial-type insurance” shall not include charitable gift annuities.

Section 501(m)(5) of the Code provides that the term “charitable gift annuity” means an annuity if (i) a portion of the amount paid in connection with the issuance of the annuity is allowable as a deduction under section 170 or 2055, and (ii) the annuity is described in section 514(c)(5) (determined as if any amount paid in cash in connection with such issuance were property).

Section 511(a) of the Code, in part, imposes a tax for each taxable year on the unrelated business taxable income of every organization that is described in section 501(c)(3).

Section 512(a)(1) of the Code provides that the term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions which are directly connected with the carrying on of such trade or business, both computed with certain modifications.

Section 513(a) of the Code provides that the term “unrelated trade or business” means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes from the profits derived) to the exercise or performance by such organization of its charitable or other purpose or function constituting the basis for its exemption under section 501.

Section 514(a)(1) of the Code provides that, in computing the unrelated business taxable income for any taxable year, a percentage of net income derived from debt-financed property should be included.

Section 514(b)(1) of the Code provides that the term “debt-financed property” means any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year.

Section 514(c)(5) of the Code provides that the term “acquisition indebtedness” does not include an obligation to pay an annuity which (A) is the sole consideration issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90 percent of the value of the property received in the exchange; (B) is payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time; and, (C) is payable under a contract which (i) does not guarantee a minimum amount of payments or specify a maximum amount of payments, and (ii) does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

Analysis:

The annuity contract that M proposes to issue to C provides for an annuity that will be payable over the lifetime of one individual in being at the time the annuity is issued. The fact that the amount of the annual annuity is dependent on the date at which C elects to begin the payments does not alter the fact that those payments will be made over the life of C. The annuity contract does not guarantee a minimum nor specify a maximum number of payments, nor does it provide for adjustment by reference to the income received from the transferred property or any other property. The only way in which the annuity payment is adjusted is based upon the age of C at the time the payments commence as determined by the table forming a part of the annuity contract. Since the requirements of section 514(c)(5) are met, the annuity contract is described in that section, and is, therefore, within the definition of charitable gift annuity in section 501(m)(5).

Historically, it appears that the issuance of charitable gift annuities has been treated as a borrowing of money by the issuing organization and the sales aspect of the transaction has been ignored. It is for this reason that the defining elements of a charitable gift annuity are found in section 514(c)(5) of the Code, since that provision exempts qualifying annuity contracts from being considered acquisition indebtedness which might otherwise lead to interest, rents, or dividends earned by charities from investment of donations received in exchange for annuity

contracts being treated as unrelated debt-financed income. Viewed as the borrowing of money which is statutorily removed from the definition of acquisition indebtedness, the appropriate focus when analyzing a proposed charitable gift annuity is on the borrowing, and not on the terms of its repayment.

In the case of the annuity contract which M proposes to issue to C, the manner in which the borrowing is repaid by M is irrelevant so long as the requirements of section 514(c)(5) of the Code are met. Here, the parties have chosen to provide a deferred annuity contract, payable over the life of the annuitant, that allows the annuitant to elect the starting date of the annuity payments. M is prepared to pay a larger annual annuity with each year that C defers the starting date of the annuity, and the contract contains a table specifying the amount of the annual annuity payment depending on the age of C in the year payments commence. However, regardless of the year in which payments commence, the deferred annuity will be payable over the life of C.

Since the annuity contract meets the requirements of section 514(c)(5) of the Code, and a charitable contribution income tax deduction under section 170 may be allowable when C makes a contribution to M in exchange for the annuity contract, the contract meets the definition of section 501(m)(5) and, in accordance with section 501(m)(3)(E), will not constitute "commercial-type insurance." The activity of M in providing this type of deferred charitable gift annuity should, therefore, not be treated under section 501(m)(2) as unrelated trade or business as defined in section 513(a).

Conclusion:

Accordingly, based on the information submitted, we rule as follows:

1. The activity of M in providing the deferred charitable gift annuity to C as described above will not be treated under section 501(m)(2) of the Code as unrelated trade or business as defined in section 513(a).
2. The proposed annuity contract fits within the annuity exception to the definition of "acquisition indebtedness" set forth in section 514(c)(5) of the Code and, therefore, the income earned by M from investment of the annuity funds will not be unrelated debt-financed income under section 514.
3. The annuity contract issued by M to C as described above meets the requirements of a charitable gift annuity as defined in section 501(m)(5) of the Code.

These rulings are made on the understanding that there will be no material changes in the facts upon which they are based.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

This ruling letter 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 as precedent.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representative. A copy of this letter should be kept in M's 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.

Sincerely,

Charles Barrett

for Joseph Chasin
Manager, Exempt Organizations
Technical Group 2