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

200233023

Date: MAY 2 0 2002

Contact Person:

SIN: 514.07-00

Identification Number:

Telephone Number:

T:ED:B4

Employer Identification Number:

Dear Sir or Madam:

This **is** in response to your letter of September 5,2001, and previous correspondence from your authorized representatives, who have requested certain rulings on your behalf.

You are a charitable and educational institution exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). You have been classified as an educational organization under sections 509(a)(1) and 170(b)(1)(A)(ii).

You propose to institute a Tuition Plan ("the Plan"), which will be maintained and administered under a Tuition Plan Agreement. You intend to engage in the sale of deferred gift annuities to benefit the recipients of such annuities from various donors (respectively, "Recipient(s)" and Donor(s)"), as well as yourself. Each Donor will make a contribution of cash or property to you in retum for a deferred gift annuity based on the life of the child. The Donor will designate a primary Recipient and may designate one alternate. The Recipient is entitled to a lifetime payout, but has the option to sell or assign his or her annuity to you or to a third party in return for a lump sum payment or installment payments over several years.

Funds received under the Plan will be added to your general funds. In exchange, you will be obligated to pay the deferred annuity from your general funds. Two different Donor Agreements will be available, and each provides that you will make payments over the lives **of** one or *two* individuals

As the purpose of the annuity is to provide funds for education, it is contemplated that Recipients will use funds generated by the annuity to attend college at your institution. However, this is not required, and Recipients may in fact use the funds for any purpose

Section 511 of the Code provides, in part, for the imposition of tax on the unrelated business taxable income of organizations described in section 501(c), including organizations 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 (as defined in section 513) that it regularly carries on, less the allowable deductions which are directly connected with the carrying on of such trade or business, and computed with the modifications contained in section 512(b).

Section 512(b)(1), (2), (3). and (5) of the Code excludes from the computation of unrelated business taxable income amounts including interest, dividends, annuities, royalties, rent from real property, and gain from the sale of property.

Section 512(b)(4) of the Code provides that notwithstanding section 512(b)(1), (2). (3). or (5), in the case of debt-financed property (as defined in section 514) there shall be included as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

Section 514(a) of the Code provides that unrelated business taxable income shall include a percentage of net income derived from debt-financed property.

Section 514(b)(1) of the Code defines the term "debt-financed property" as any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year (or during the 12 months preceding disposition in the case of property disposed of during the taxable year).

Section 514(c)(1) of the Code defines "acquisition indebtedness." with respect to any debt-financed property, as the unpaid amount of

(A) the indebtedness incurred by the organization in acquiring or improving such property;
(B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and,
(C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of acquisition or improvement.

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 the 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 does not guarantee a minimum amount of payments and 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.

Section 501(m)(1) of the Code provides that an organization described in section 501(c)(3) or (4) 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 if an organization described in section 501(c)(3) or (4) provides insurance as an insubstantial part of its activities, the activity of providing commercial-type insurance shall be treated as an unrelated trade or business (as defined in section 513). or in lieu of the tax imposed by section 511, the organization shall be treated as an insurance company for purposes of applying Subchapter L with respect to such activity.

Section 501(m)(4) of the Code states that the issuance of annuity contracts shall be treated as providing insurance. However, section 501(m)(3)(E) provides that the term "commercial-type insurance" does not include charitable gift annuities.

Section 501(m)(5) of the Code provides that the term "charitable gift annuity" means an annuity if-

(A) a portion of the amount paid in connection with the issuance of the annuity is allowable as a deduction under sections 170 or 2055, and
(B) the annuity is described in section 514(c)(5) (determined as if any amount paid in cash in connection with such issuance were property).

In order to determine whether income earned by the Plan will be subject to the tax on unrelated business income, it is necessary to review the rules applicable to charitable gift annuities. Section 501(m)(3)(E) of the Code added the term "charitable gift annuities" to the list of exceptions to commercial-type insurance. Section 501(m)(5) refers to an annuity being described in section 514(c)(5) and sets forth the requirement that a portion of the amount paid must be allowable as a deduction under sections 170 or 2055.

In our view, by enacting section 501(m)(3)(E) of the Code, Congress clarified that the issuance of charitable gift annuities does not constitute an unrelated trade or business under section 513. This is supported by the legislative history accompanying this provision, which indicates that under prior law all income resulting from the issuance of charitable gift annuities was exempt from tax.

Section 514(c)(5) of the Code specifically exempts "charitable gift annuities" from being considered "acquisition indebtedness" and thereby ensures that the interest, rents or dividends secured from the investment of the proceeds an organization receives from issuing these annuities will not be subject to the unrelated business income tax. This exception from the

debt-financed income provisions would be virtually useless if the proceeds themselves were subject to the unrelated business income tax. Accordingly, any income generated from the issuance of charitable gift annuities described in section 514(c)(5) is not subject to the tax on unrelated business income.

Here, the available information indicates that the Plan meets each of the requirements under section 514(c)(5). The annuity will be the sole consideration issued in exchange for the property; it will be payable over the life of one (or two individuals), and it will be payable under a contract which will not guarantee a minimum amount of payments and will not provide for any adjustment of the amount of the annuity payment by reference to the income received from the transferred property or any other property.

As noted previously, section 501(m)(3)(E) of the Code provides, in pertinent part, that a "charitable gift annuity" must have, as a portion of the amount paid in connection with the issuance of the annuity, an amount that is allowable as a deduction under section 170. Although the Service is not issuing rulings under section 170 with respect to this matter, we have determined that

(1) A donor/transferor to you in conjunction with the Plan, who transfers to you an amount greater than the present value of the annuity to be provided to the recipient(s) designated by the donor/transferor, will, assuming that neither the donor/transferor nor any other person designated by the donor/transferor receives anything back from you otherthan such annuity, be entitled to a charitable contribution deduction under section 170 for the excess of the amount transferred over the present value of the annuity; and

(2) Such donor/transferor's transfer to the Plan and subsequent payments by you of the annuity selected by the donor/transferor are not contributions by the donor/transferor of a remainder interest in trust and are instead a purchase by the donor/transferor of a deferred gift annuity.

Based on the information presented, we rule as follows:

The Plan fits within the annuity exception to the definition of "acquisition indebtedness" set forth under section 514(c)(5) of the Code, and thus, all income earned by the Plan will not be taxable as unrelated business taxable income.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is 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.

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 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,

(signed) Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Branch 4