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

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Significant Index Numbers:

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Employer Identification Number:

Contact Person:

ID Number:
OP:E:EO:T:4

Telephone Number:

Legend:

M =
N =
O =

Facts:

This is in reply to your request for a ruling dated November 3, 1997, regarding the proposed transaction described below.

M is a charitable remainder unitrust within the meaning of Section 4 of Rev. Proc. 90-31, 1990-1 C.B. 539, and Internal Revenue Code section 664(d)(2) and (3). M proposes to create and provide funds for N, which will be a foreign corporation wholly owned by M. M will not incur debt in order to create and fund N.

N will be governed by the law of O. It will be treated as a corporation for U.S. income tax purposes. All corporate formalities with respect to N will be followed, the status of N and its assets as separate from M and its assets will be observed, and N will not act as the agent for M or M's trustee.

M's trustee anticipates that N will purchase an interest in a U.S. partnership (the Fund). The Fund has acquired and will acquire and actively manage a diverse portfolio of primarily below investment-grade securities, with the objective of providing its investors with high yield annual returns. The Fund anticipates use of debt financing to partially fund its acquisition of investment assets. The anticipated use of debt financing will result in income that is considered to be unrelated business taxable income (UBTI) to holders of interests in the Fund for purposes of sections 511 and 664(c).

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The debt-financed income will be distributed to N and which N may then distribute to M.

M states that it has four business purposes for establishing N: flexibility in disposing of interests in the Fund, additional limited liability protection, avoiding unrelated business taxable income, and management of additional investments to be made by M.

Based on these representations, M has requested the following rulings:

1. N's distributive share of the Fund's income and gains under section 704 of the Code will not constitute unrelated business taxable income to M.

2. The amounts distributed by the Fund to N will not constitute unrelated business taxable income to M.

3. The amounts distributed by N to M will not constitute unrelated business taxable income to M.

Law:

Section 511 (a) of the Code imposes a tax upon the UBTI of organizations exempt from tax under section 501(a) of the Code.

Section 512(a)(1) of the Code defines UBTI as the gross income derived from an unrelated trade or business regularly carried on, less allowable deductions, and subject to certain modifications.

Section 512(b)(1) of the Code provides that dividends received or accrued shall be excluded from UBTI.

Section 512(b)(4) of the Code provides that notwithstanding the general exclusion of dividends from UBTI, dividends and other passive investment income derived from certain debt-financed property (and corresponding deductions) are included, as an item of gross income derived from an unrelated trade or business, in an amount ascertained under section 514 of the Code.

Section 512(b)(13) of the Code, as amended by the Taxpayer Relief Act of 1997, provides that certain items of income received from a controlled entity will be considered to be derived from an unrelated trade or business. Dividends are not included among the items of income covered by section 512(b)(13) of the Code.

Section 512(b)(17) of the Code, added by the Small Business Job Protection Act of 1996, provides that any amount included in gross income under section 951(a)(1)(A) shall be included as an item of gross income derived from an unrelated trade or business to the extent that the amount so included is attributable to insurance income as defined in section 953 of the Code.

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code defines unrelated trade or business as any trade or business, the conduct of which is not substantially related to the performance of exempt purposes or functions.

Section 514 of the Code provides that the term "unrelated business income" includes "unrelated debt-financed income" from investment property. The investment income included is proportionate to the debt on the property.

Section 514(b) 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 acquisition indebtedness at any time during the taxable year

Section 664(c) of the Code provides that a trust is exempt from income taxes for any taxable year unless the trust has UBTI for such year. If the trust has UBTI for any taxable year, then the trust is not exempt from taxes, and is subject to taxation under the normal rules of Subchapter 1 of the Code.

The House Ways and Means Committee Report on the Small Business Job Protection Act of 1996, in describing section 512(b)(17), states that "income inductions under Subpart F have been characterized as dividends for unrelated business income tax purposes."

Sections 951 through 964 comprise Subpart F – Controlled Foreign Corporations. Section 951(a)(1)(A) provides that a United States shareholder of a controlled foreign corporation must include in gross income his pro rata share of the controlled foreign corporation's Subpart F income for the year,

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even if not distributed. Section 954(c)(1) of the Code provides that Subpart F income includes investment income.

Analysis and Conclusion:

Prior to the enactment of section 512(b)(17) of the Code in 1996, it was unclear whether exempt organizations that conducted insurance activities through a foreign corporation were subject to U.S. tax with respect to such activities. The Internal Revenue Service issued a series of private letter rulings stating that amounts distributed by the controlled foreign corporation (and thus includible in its shareholders' income under Subpart F) were characterized as dividends for unrelated business income tax purposes and thus were not taxed. But a private letter ruling to the contrary was also issued. (PLR 9043039)

Section 512(b)(17) of the Code was enacted to provide that where a controlled foreign corporation is insuring third-party risks (providing insurance to entities other than the exempt organization which controls the controlled foreign corporation and certain related parties), the income from that activity will be taxable as unrelated business income. The House Ways and Means Committee Report on the new provision discusses favorably the rulings issued by the Service which characterized Subpart F inclusions as dividends and thus not taxable as unrelated business income. The Committee Report also refers unfavorably to a ruling (PLR 9043039), which used a look-through rule to characterize Subpart F income.

In the case at hand, the income derived by N from the Fund will not be insurance income as defined in section 953 of the Code. It appears clear that Congress intended such noninsurance income to be treated as dividend income when paid to shareholders of controlled foreign corporations.

Under sections 512(c), 512(b)(4), and 514, income from the Fund would be UBIT to M if received directly by M because it is debt-financed income. However, here the income will arrive at M indirectly through N, which will pay dividends to M. Dividend income is not taxable under section 512(b)(1) of the Code. Further, M has not itself incurred debt in financing its interest in N, and thus such dividend income is not debt-financed income described in section 514.

Based upon the information submitted, we rule as follows:

1. N's distributive share of the Fund's income and gains under section 704 of the Code will not constitute unrelated business taxable income to M.

2. The amounts distributed by the Fund to N will not constitute unrelated business taxable income to M.

3. The amounts distributed by N to M will not constitute unrelated business taxable income to M.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any changes that may have bearing upon your tax status should be reported to the Service.

A copy of this ruling is being sent to your key District Director. Because it could resolve questions concerning your federal income tax status, this ruling should be kept with your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited 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. For other matters, including questions concerning reporting requirements, please contact your key District Director.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Branch 4

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