401.01-01
503.02-00

Internal Revenue Service

199943039

Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

Date: OP:E:EP:T:5

JUL 9 1999

Legend:

Company A =
Company B =
Company C =
Congregation =

Church =
State D =
Plan X =

Plan Y =

Sirs and Madams:

This is in response to your request for a ruling dated July 6, 1998, submitted by your authorized representative, as supplemented by correspondence dated May 10, 1999, in which you request several letter rulings under sections 503 and 401(a)(2) of the Internal Revenue Code. The following facts and representations have been submitted in support of your request.

Company A is a corporation organized as a membership corporation under the State D Nonprofit Corporation Act. Company A is indirectly controlled by the Congregation, a religious congregation of women which is part of the Church. Company A is engaged, directly and through affiliates and subsidiary corporate entities, in the provision of hospital and health care services in several states and qualifies as a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code.

Company A sponsors two tax-qualified employee retirement plans described in Code section 401(a), Plan X and Plan Y.

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Plan X is a defined benefit plan that was established, effective ********** for the benefit of Company A's employees at selected operating units. The Internal Revenue Service has issued a favorable determination letter that considered the amendments required by the Tax Reform Act of 1986 with respect to Plan X. Plan X has also received a ruling from the Internal Revenue Service that as of ******* ******** it is a church plan within the meaning of section 414(e) of the Code.

Plan Y is a defined contribution plan that was established, effective ********** for the benefit of Company A's employees, other than employees who are members of a unit of employees represented by a collective bargaining agent where retirement benefits were the subject of good faith bargaining and leased employees. Plan Y is intended to satisfy the requirements of a church plan under section 3(33) of ERISA and Internal Revenue Code section 414(e). Company A has not requested a ruling that Plan Y is a church plan within the meaning of section 414(e) of the Code. Company A has not submitted and, under Notice 96-64, 1996-2 C.B. 229, has not yet been required to submit Plan Y to the Internal Revenue Service for a determination that Plan Y is a qualified plan under section 401(a) of the Code. However, Company A will submit Plan Y to the Service for such a determination before the expiration of the period authorized therefor.

Plan X and Plan Y are administered by the Pension Committee for Plans X and Y (the Committee). The primary purpose of the Committee is to administer Plan X, Plan Y, and other nonqualified plans maintained by Company A.

The trustees of Plan X and Plan Y currently invest the Plans' assets, which total approximately ********** in a diversified portfolio through the appointment of various investment managers. In addition, Company A invests significant cash and endowment funds, reserve funds, liability trust reserves, and other similar assets (collectively the "general assets"), totaling approximately **********. Company A currently engages the services of ten different investment managers to manage these assets.

In order to reduce the administrative costs associated with the investment of the Plans' assets and Company A's general assets, Company A is proposing to commingle the assets of Plan X and Plan Y with its general assets for investment purposes ("the Program"). Separate accounting will be maintained under the Program for the Plans' assets and Company A's general assets. By commingling the Plans' assets with Company A's general assets, Company A will be able to obtain the services of certain investment managers who charge a lower fee for their services but who require a

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minimum investment for the establishment of an account with such manager. Company A does not anticipate changing the classes of securities in which the Plans' assets and its general assets are currently invested and therefore does not believe that the risks associated with the investment of the Plans' assets or its general assets will increase by reason of the establishment of the Program.

Company A will establish portfolios and pools as the investment vehicles for the commingled assets. The portfolios will reflect the differences in the underlying purposes of the assets to be held by such portfolios and the pools will reflect different types of securities available for investment. Each portfolio will be organized in the form of a group of entities acting as co-owners (tenants in common) of the assets held in such portfolio. The portfolios will not be separate legal entities and will have no physical facilities or employees. Rather, the portfolios are intended to operate and function as unregistered open end investment entities similar to mutual funds. Further, in reliance on certain exemptions under federal securities laws, Company A does not expect that it will be required to register the portfolios and pools as investment companies.

Company A proposes to establish *** portfolios and **** pools. The portfolios will include an ********** Portfolio, a ********** Portfolio, a ********** Portfolio, a ********** Portfolio, a ******* Portfolio, and a ********** Portfolio. The pools will include an ********** Pool, a ********** ****** Pool, a ********** Pool, a ********** Pool, and an ********** Pool. Each pool will have distinct investment objectives.

Each health care provider or other entity participating in the Program will initially invest its assets in one or more portfolios. The portfolios in turn will invest all of their assets directly in one or more pools. Each entity will own an undivided interest in the assets of one or more portfolios and each portfolio will own an undivided interest in the assets of one or more pools. As indicated above, separate accounting of each entity's interest in the portfolios and pools will be maintained.

With respect to the interests of Plan X and Plan Y in the Program, the Plans' assets will be invested in the ******* Portfolio which, in turn, will be invested in one or more pools. The trust holding the Plans' assets will own the interest in the ******* Portfolio and will have all legal and equitable rights ordinarily retained by a tenant in common.

Each pool will be organized in the form of a group of the participating portfolios acting as co-owners (tenants in common) of the assets held in such pool. Because no corporation or other formal entities are being formed to represent the portfolios or pools, each participating entity in a given portfolio will, pro rata in accordance with its interests as a tenant in common, be deemed for tax and financial reporting purposes to have an undivided interest in the securities held by the pools in which that portfolio invests.

The pools will invest their assets through one or more investment managers who meet the U.S. Securities and Exchange Commission's requirements for a qualified investment manager. The investment managers will purchase and actively manage securities on behalf of their pools. No investment manager will be responsible for investing the assets of more than one pool except that it is expected that short-term cash balances in all pools may be invested through a single investment manager.

Company B or any other qualified custodian as Company A may designate from time to time will serve as the custodian of all securities owned by the pools. The custodian will provide bookkeeping and valuation services with respect to the assets held by each portfolio and pool. The custodian and Company A or its nominee will reflect ownership of assets in the portfolios and pools on a book-entry basis. The custodian will also enter into separate custody agreements with each investment manager and the pool making investments with such investment manager. The custodian will also act as agent for the Program in connection with secured loans of investment securities held in the Program. Gross income from securities lending activity will be allocated *** to the program and *** to the custodian for its additional services in arranging the loans, holding and monitoring the collateral therefore, and collecting income thereon. Any net income arising from securities lending activities which is distributable to the Program participants will be allocated pro rata to the pools from which the securities were borrowed. Legal title to the securities, cash, and other assets comprising the portfolios and pools will be held by the custodian on behalf of the participating tenants in common. Equitable and beneficial title will be held by the tenants in common as undivided interests in each asset.

The relative interest of each entity investing in a portfolio will be designated and tracked on a unit basis and the relative interest of a given portfolio in the pools in which it invests will similarly be designated and tracked on a unit basis. Units in the ********** Portfolio and the related ********** Pool will have a fixed value of *****

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per unit. Income from the ********** portfolio and the ********** Pool, substantially all of which will be interest income rather than income arising from the purchase and sale of underlying securities, will be distributed through the issuance of additional units in proportion to each entity's average unit holdings over a given period of time. Units in the other portfolios and pools will have a variable value based upon the underlying net asset value of the securities and cash held, directly or indirectly, by the pool or portfolio and will be determined periodically by the custodian.

The custodian will provide each entity with a monthly statement reflecting the number and value of units held by the entity in each portfolio and the number and value of units held by the portfolios in the pools as of the end of such month. This statement will also reflect additional investments or withdrawals made during the month. Withdrawals from a portfolio will generally be in cash. Upon the occurence of certain events, however, an entity may request a withdrawal of the specific securities held for investment in the form of an in-kind distribution of its beneficial interest in the underlying assets.

Investments in and withdrawals form a portfolio, other than the ********** Portfolio, will generally be made only as of the first business day of the month and will be valued based upon the per-unit value of the portfolio determined as of the close of business on the preceding business day. Any assets transferred to the portfolio during the month will be held in a separate interest-bearing account maintained by the portfolio and then converted, together with income thereon, to units as of the first business day of the following month. Withdrawals from a portfolio of less than all assets invested by an entity in such portfolio at any time other than immediately following a regular determination of the portfolio's per-unit value will require the consent of Company A or other entity as Company A may designate and a special valuation, the costs of which will be charged to the entity requesting such withdrawal. Investments or withdrawals at the portfolio level may result in related investments or withdrawals at the pool level, which would, in turn, result in additions to or withdrawals from accounts maintained with an investment manager. No secondary market or trading in portfolio units will be created or permitted to exist.

Investments in and withdrawals from the ********** Portfolio may be made as often as necessary to meet each entity's operating needs. Company A anticipates that the ********** Portfolio will function in connection with the cash management system maintained by Company A and its affiliated entities. Under this system, cash will be transferred to the ********** Portfolio by "sweeping"

the participating entity's bank depository accounts on a daily basis, resulting in credits to the entity's account in the ********** Portfolio, and debiting the entity's account in the ********** Portfolio to fund payment of checks issued by such entity. Cash transferred to the ********** Portfolio will be invested in short-term fixed-income instruments.

Company A has created a new subsidiary, initially identified as Company C, to provide in-house management and reporting services in connection with the Program. Company C has been organized as a nonprofit corporation under State D law and intends to qualify as a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code. Company A's employees will provide these services on behalf of Company C. Company C will enter into an Investment Account Agreement ("Agreement") with each entity investing in a portfolio. The arrangement will be treated as a non-partnership for tax-reporting purposes. The Agreement will:

(1) specify the portfolio involved and authorize Company C to commingle the assets of that portfolio with the assets of one or more other portfolios for investment in one or more pools;

(2) designate Company C as the agent and attorney in fact of the participating entity as necessary to carry out the Program;

(3) authorize Company C to act as nominee for the participating entity for purposes of voting any securities held, directly or indirectly, by the portfolio;

(4) direct Company C to enter into custodial agreements with the custodian relating to the assets of the portfolio and pools and to enter into investment management agreements with registered investment managers who will provide active management services for the pools and such other agreements as may be appropriate to administer the Program;

(5) direct Company C to reallocate portfolio assets among the pools to designated investment levels as of the end of each calendar quarter (and on certain interim bases) and to reallocate the assets held by the pools among the investment managers;

(6) authorize Company C to charge third-party operating expenses to the appropriate portfolio or pool;

(7) authorize Company C, subject to certain limits, to charge its costs and expenses to the appropriate portfolio or pool;

(8) specify the timing of investments in and withdrawals from the portfolio and pools, including notice requirements relating to such investments and withdrawals;

(9) require Company C to provide the participating entity with a monthly statement reflecting the number and value of units held by such entity in the portfolio and the number and value of units held by the portfolio in the pools, an annual statement of income and investment gain or loss and a summary report indicating changes in unit values and investment performance since the inception of the Program;

(10) require the participating entity to acknowledge the investment risks inherent in the Program and to acknowledge that neither Company C nor Company A has guaranteed any specific investment return or performance; and

(11) specify that the Agreement is subject to renewal on an annual basis.

Company A will establish investment parameters and guidelines to govern Company C's allocation of each portfolio's assets among the pools. The guidelines will be approved by Company A's Board of Directors and the Committee. In establishing the guidelines, Company A will rely on recommendations from its Board of Directors and the Committee, as well as its finance department and independent investment advisors and investment managers engaged for the actual investment of assets in the Program. At the end of each calendar quarter, Company C will reallocate the portfolio's assets among the pools in which it participates in order to maintain the levels of investment approved by Company A's Board of Directors and the Committee. Company C will have discretion to reallocate the portfolio's assets on an interim basis within a given calendar quarter if market conditions result in a variance of more than ** from the established investment levels. If Company C invests the assets of any Pool through more than one investment manager, Company C will allocate such assets among the multiple investment managers in accordance with guidelines established by Company A.

An entity may participate in the Program by selling its assets to the applicable portfolio and simultaneously investing the proceeds from that sale in the portfolio. The terms of the sale will not be less favorable to the entity than similar terms negotiated at arm's length between unrelated third parties and the sales price will not be less than fair market value.

The costs and expenses related to the establishment and operation of the Program will be allocated as follows:

(1) Investment managers' fees and related custodial expenses of the custodian will be charged against the assets under each independent manager's control;

(2) The custodial and bookkeeping fees of the custodian with respect to the portfolios and pools will be allocated among and paid by the portfolios and pools quarterly in proportion to the average assets held in each such portfolio or pool; provided, that fees associated with the cash management system will be allocated to the ********** Portfolio;

(3) Tax return preparation and audit fees, if any, applicable to the portfolios and pools will be allocated among the portfolios and pools on a direct-cost basis;

(4) Company A will recover its and Company C's costs of managing the Program primarily through management fees charged to its affiliates for general overhead and administration. It is anticipated that outside participants, if any, will be charged a negotiated management fee which is expected to be less than **** of their respective average assets participating in the Program; and

(5) Costs incurred by a particular entity, such as special valuation costs, will be allocated to such entity through a redemption of such entity's units in the appropriate portfolio in an amount sufficient to cover such costs.

The decision whether to participate in the Program and invest the Plans' assets in the ******* Portfolio will be made by the Trustees of Plan X and Plan Y acting independently of Company A or Company C following full disclosure to such tustees of all relevant information regarding the Program. Such information will include, but is not limited to, a detailed description of the structure

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and investment policy of the ******* Portfolio and each of the pools, a description of the fees and expenses to be charged to the ******* Portfolio and each of the pools, a statement of the particular investments to be held by the ******* Portfolio and a description of the investment managers who will invest the assets of the pools. In addition, Company A or Company C will provide or make available to the trustees such information as is necessary to allow the trustees to determine whether or not to continue to participate in the Program.

Although Company A has structured the Program to meet the needs of Company A and entities controlled by or under common control with Company A, Company A anticipates that a limited number of affiliated but non-controlled entities with which Company A is or may become associated in the operation and delivery of health care services may also participate in the Program.

Based upon the foregoing facts and representations, your authorized representative has requested the following rulings:

(1) The investment by Company A of the assets of Plan X and Plan Y and the general assets of Company A in the portfolios and pools does not constitute a prohibited transaction within the meaning of section 503 of the Internal Revenue Code.

(2) The investment by Company A of the assets of Plan X and Plan Y and the general assets of Company A in the portfolios and pools will not affect the qualification of Plan X or Plan Y under section 401(a) of the Internal Revenue Code.

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in sections 401(a) and 501(c)(3). Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 401 of the Internal Revenue Code provides rules regarding qualified pension, profit-sharing, and stock bonus plans. Section 401(a)(1) of the Code provides, in general, that a trust created or organized in the United States and forming part of a stock, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries shall be qualified under this section if contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated in accordance with such plan.

Section 4975 of the Code imposes an excise tax on certain prohibited transactions involving a plan. However, section 4975(g)(3) provides that section 4975 is not applicable to a "church plan" within the meaning of section 414(e) with respect to which the election provided by Code section 410(d) has not been made.

Section 503(a)(1)(B) of the Internal Revenue Code provides, in part, that an organization described in section 4975(g)(3) of the Code shall not be exempt from taxation under Code section 501(a) if it has engaged in a prohibited transaction after March 1, 1954.

Section 503(b) of the Code provides that the term "prohibited transaction" means any transaction in which a church plan-

(1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) makes any part of its services available on a preferential basis to;

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c)(4) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50% or more of the total value of shares of all classes of stock of the corporation. In this case, the creator of the Code section 401(a) organization is Company A.

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Section 401(a)(2) of the Code provides that in order for a trust to be qualified, it must be impossible under the trust instrument at any time prior to satisfaction of all liabilities with respect to the employees and their beneficiaries for any part of the corpus or income to be used for or diverted to purposes other than the exclusive benefit of the employees or their beneficiaries.

Section 1.401-2(a)(3) of the Income Tax Regulations provides that for purposes of Code section 401(a)(2) the phrase "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

Section 1.401-1(b)(3) of the regulations provides that the law concerning plan qualification is concerned not only with the form of a plan, but also with its effects in operation. Thus, a plan must comply with the exclusive benefit rule in operation as well as in form.

Section 1.401-1(b)(5)(i) of the regulations provides that no specific limitations are provided in Code section 401(a) with respect to investments which may be made by the trustees of the trust qualifying under Code section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law.

Revenue Ruling 69-494, 1969-2 C.B. 88, states that the primary purpose of benefiting employees or their beneficiaries must be maintained with respect to the investments of the trust funds as well as with respect to other activities of the trust. Rev. Rul. 69-494 further provides that this requirement, however, does not prevent others from also deriving some benefit from a transaction with the trust. In this regard, Revenue Ruling 71-391, 1971-2 C.B. 186, holds that a profit-sharing plan does not fail to qualify under Code section 401(a) merely because distributions made upon termination of a participant's-service may result in a reduction of the amounts the employer might otherwise have to contribute under the state unemployment compensation law. Rev. Rul. 71-391 further provides that the distributions in this case made upon termination of a participant's service are for the employee's benefit and represent the total amount to which he is entitled at the time of separation.

Sections 1.401-1(b)(2) through (5) of the regulations provide examples of situations in which plans will or will not qualify as plans for the exclusive benefit of employees.

Section 1.401-1(b)(3) of the regulations states, in part, that a plan will not qualify as a plan for the exclusive benefit of employees if it is so designed as to amount to a subterfuge for the distribution of profits to shareholders and that a plan is not for the exclusive benefit of employees in general if it discriminates in eligibility requirements, contributions or benefits in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees or highly compensated employees.

Section 1.401-1(b)(5)(ii) of the regulations states, in part, that where trust funds are invested in stock or securities of or loaned to the employer or other person described in section 503(b), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees.

Section 404(a)(1)(B) of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), provides that a fiduciary shall discharge its duties with respect to a plan solely in the interest of the participants and their beneficiaries and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. This is commonly referred to as the "prudent man rule." Revenue Ruling 69-494 holds that before an investment of funds from a qualified plan in employer stock or securities will satisfy the exclusive benefit rule of Code section 401(a), the safeguards and diversity that a prudent investor would adhere to must be present.

Section 2550.404a-1(b) of the U.S. Department of Labor regulations provides that ERISA section 404(a)(1)(B) is satisfied if the fiduciary has given "appropriate consideration" to the facts and circumstances relevant to an investment and the fiduciary has acted accordingly. Under these regulations "appropriate consideration" includes at least two elements. First, there must be a determination by the fiduciary that the particular investment or investment course of action is reasonably designed as part of a portfolio to further the purposes of the plan taking into consideration risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. Second, there must be consideration of the following three factors as they relate to such portios of the portfolio: (1) the composition of the portfolio with regard to diversification, (2) the liquidity and current return of the portfolio relative to the anticipated cash

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flow requirements of the plan, and (3) the projected return of the portfolio relative to the funding objectives of the plan.

In this case, the trustees of Plan X and Plan Y currently invest the Plans' assets in a diversified portfolio through the appointment of various investment managers. Under the proposed Program, all plan assets will be invested through one or more investment managers who meet the Securities and Exchange Commission's requirements for a qualified investment manager. Company B or another qualified custodian will serve as the custodian of all securities purchased through the Program. The assets of Plan X and Plan Y will continue to be used to provide benefits to plan participants and their beneficiaries in accordance with the terms of the plan documents. No plan assets (or any income therefrom) will be loaned to Company A or Company C; used to pay fees in excess of a reasonable fee to Company A or to Company C for their services in connection with the Program; used to purchase securities or other property from Company A or Company C for more than adequate consideration; or used to engage in any other transaction which will result in a substantial diversion of such assets to Company A or Company C.

Under the proposed Program separate accounting will be maintained for the Plans' assets and the general assets of Company A. Company A will establish portfolios and pools as the investment vehicles for the commingled assets. Each participating entity will own an undivided interest in the assets of one or more portfolios and each portfolio will own an undivided interest in the assets of one or more pools. The portfolios will not constitute separate legal entities or trusts, and each portfolio is intended to operate and function as an unregistered open end investment company similar to a mutual fund. The relative interest of each entity investing in a portfolio will be designated and tracked on a unit basis and the relative interest of a given portfolio in the pools will similarly be designated and tracked on a unit basis. With respect to the qualified plans' interest in the Program, the plan assets will be invested in the ******* Portfolio. The Trustees will retain ownership interest of the plan investments in the ******* Portfolio, holding all legal and equitable rights to such investments. Legal title to the actual securities, cash, and other assets comprising the portfolios and pools will be held by a custodian on behalf of the participating entities as tenants in common. Equitable and beneficial title will be held by the tenants in common as undivided interests in each asset.

Company A will establish investment parameters and guidelines to govern Company C's allocation of each Portfolio's assets among the pools. The guidelines will be

approved by the Board of Directors of Company A and the Committee. The decision whether to participate in the Program and invest the Plans' assets in the Pension Portfolio will be made by the Trustees of Plan X and Plan Y acting independently of Company A or Company C following full disclosure to such Trustees of all relevant information regarding the program.

Under the facts presented in this case, the transactions proposed by Company A do not fall within the scope of prohibited transactions under section 503(b) of the Code, and the investment program proposed by Company A with regard to Plan X and Plan Y does not fail to satisfy the exclusive benefit rules provided in section 401(a)(2) of the Internal Revenue Code.

Accordingly, we conclude with respect to your ruling requests that (1) the investment by Company A of the assets of Plan X and Plan Y and the general assets of Company A in the portfolios and pools does not constitute a prohibited transaction within the meaning of section 503 of the Internal Revenue Code; and (2) that the investment by Company A of the assets of Plan X and Plan Y and the general assets of Company A in the portfolios and pools will not affect the qualification of Plan X or Plan Y under section 401(a) of the Internal Revenue Code.

In accordance with a power of attorney on file with this office, this letter is being sent to your authorized representative.

Sincerely yours,

S/ Alan Pipkin

Alan Pipkin
Chief, Employee Plans
Technical Branch 5

Enclosures:

Notice of Intention to Disclose
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