Bond Case Briefs

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IRS LTR: Tax-Exempt Status Not Affected by Loan Servicing Activity.

The IRS ruled that an organization's activity of servicing direct student loans originated by the Education Department under the Healthcare and Education Reconciliation Act of 2010 won't affect the organization's tax-exempt status and that revenue generated from the activity won't constitute unrelated business taxable income under sections 512 and 513.

Citations: LTR 201423028

Contact Person: * * *
Identification Number: * * *
Contact Number: * * *
FAX Number: * * *

UIL: 501.03-00, 512.00-00, 513.00-00
Release Date: 6/6/2014
Date: March 12, 2014

Employer Identification Number: * * *

LEGEND:
State = * * *
Commission = * * *
Year = * * *

Dear * * *:

This is in response to your letter dated December 3, 2010, requesting a ruling relating to changes in your federal student loan activities as a result of the 2010 Healthcare and Education Reconciliation Act of 2010 (HCERA).

FACTS

You are a nonprofit organization incorporated under the laws of State and recognized as exempt from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code (Code) and as a publicly supported organization under §§ 170(b)(1)(A)(vi) and 509(a)(1). You were formed at the request of the then-governor of State to facilitate and promote post-secondary education in State by financing the purchase, sale, and general marketing of student loans guaranteed by the U.S. government under the Higher Education Act of 1965 (HEA).
In a designation letter, the governor of State specifically requested that you:

. . . assist [State] by making arrangements necessary for providing a statewide student loan acquisition program through a not-for-profit corporation [under the HEA] . . . [You] should be established and operated exclusively for the purpose of acquiring student loan notes incurred under

the [HEA] . . . The program to be established should be as comprehensive as feasible within the limitations of the applicable provisions of federal and state law.

According to your original Articles of Incorporation (AOI), you were organized exclusively for the purpose of acquiring student loan notes incurred under the HEA and to devote any excess income to purchase additional student loan notes or to pay income to State.

On your Form 1023, Application for Recognition for Exemption, you stated that you would engage in the purchase of qualified loans from banks and other participating financial institutions. You stated that your primary activity was to purchase and service student loans guaranteed by the U.S. government made under the Federal Family Education Loan Program (FFELP), which was part of the HEA. The governor of State designated you, under the HEA, as the sole entity for State to provide funds and acquire student loan notes from lenders representing loans to State students attending schools anywhere and loans to students from other states attending State schools.

According to your AOI, your 11-member board of directors is comprised of the following members:

2 directors from State banking institutions

1 director from State savings and loan institutions

1 director from State credit unions

1 director from State regents' institutions

1 director from State private colleges and universities

1 director from State "Merged Area Schools"

4 directors from the general public

Each of your board members is, and has always been, appointed by the governor of State. Each of them serves on your board "by reason of being appointed by public officials, and some of the above persons serve as members of the governing body by reason of being public officials." Your AOI also provide that upon dissolution all of your property, after the payment of debts and expenses, will vest in and become the property of State.

Historically, you have raised revenues to purchase student loans from the sale of bonds. As your revenue base increased, you began engaging in new activities aimed at benefitting students: you established a borrower benefits program (e.g., reducing interest rates for timely payments); a private loan program to supplement the financial needs of students; an interest forgiveness program for student loans issued to U.S. military members; and a student loan forgiveness program for individuals engaged in specialized professions (e.g., nursing) in State. You also established an independent § 501(c)(3) organization to assist students in completing financial aid forms issued by the U.S. Department of Education (DOE).

In Year, under legislation enacted by the State legislature, your purposes were expanded allowing you to originate and service private loans to students who are State residents or students attending an educational institution in State. You engaged in this activity in partnership with Commission, the designated guarantor of federally guaranteed students loans originated under FFELP for the DOE.

In 2010, the U.S. Congress passed the HCERA, under which the federal government discontinued guaranteeing student loans originated under the FFELP. Instead, effective July 1, 2010, federal

student loans are now made directly by the U.S. government to borrowers. According to the floor discussion accompanying the legislation, the "provisions of this legislation will convert all new Federal student loans to the Direct Loan Program . . . saving $61 billion over the next 10 years. These changes will also upgrade the customer service borrowers receive when repaying their loans. " 156 Cong. Rec. S1923, S1984 (daily ed. Mar. 24, 2010) (Sen. Harkin).

HCERA also amended 20 U.S.C. § 1078f by adding subsection (4) which provides that the Secretary of Education may award contracts for servicing federal direct student loans to "eligible non-profit service providers."1 One of the ways to satisfy the criteria for eligible non-profit service providers is exemption under section 501(c)(3), along with other requirements. Id. The floor discussion accompanying the legislation noted: "[T]his legislation recognizes that non-for-profit servicers play a unique and valuable role in helping students in their States succeed in postsecondary education and that students should continue to benefit from the assistance provided by not-for-profit servicers." 156 Cong. Rec. S1923, S1984 (daily ed. Mar. 24, 2010) (Sen. Harkin).

Prior to HCERA, 20 U.S.C. § 1078f provided that contracts may be awarded to "only entities which the Secretary determines are qualified to provide such services and supplies and will comply with the procedures applicable to the award of such contracts." The section also contained a preference for certain state agencies since the Secretary is directed (when considering entering into agreements with entities who already have agreements under 20 U.S.C. § 1078(b) and (c)) to "give special consideration to State agencies with a history of high quality performance to perform services for institutions of higher education within their State." See 20 U.S.C. § 1078f(a)(2).

With the enactment of the HCERA, you will now service student loans owned by the federal government, rather than loans you acquire in the secondary market or originate on your own. You will also begin servicing the federal direct loans of students residing throughout the United States, rather than just State residents or non-resident students attending school in State. Initially, the minimum number of loans required by law to be allocated by the DOE to qualified non-profit corporations is 100,000. By the end of your 2014 fiscal year, you project that you will be servicing one million loans for the DOE. Your goal is to ultimately service two million or more loans for the DOE.

To effectuate your new duties, you amended your AOI to allow you to enter into contracts relating to the origination, servicing, and collection of student loans and to establish and operate data systems for the maintenance of records for the direct student loan program.

Over time, your revenue attributable to direct loan servicing will represent an increasing percentage of your total revenue. Your use of all revenue, including those generated from servicing federal direct loans, will remain substantially unchanged after the adoption of HCERA.

RULINGS REQUESTED

You have requested the following rulings:

1) Performing loan services on direct student loans originated by the DOE under the HCERA will not adversely affect your exempt status under § 501(c)(3).
2) Revenue generated from performing these loan services will not constitute unrelated business taxable income under §§ 512 and 513.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations

organized and operated exclusively for religious, charitable, or educational purposes.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in § 501(c).

Section 512(a)(1) of the Code 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 certain allowable deductions and modifications.

Section 513(a) of the Code 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 such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the functions constituting the basis for its exemption.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations (regulations) provides that to be exempt as an organization described in § 501(c)(3), an organization must be both organized and operated exclusively for one or more purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(2) of the regulations provides a definition of the term "charitable" as it is used in § 501(c)(3). The term "charitable" is used in its generally accepted legal sense and includes both the advancement of education and the lessening of the burdens of the government. Further, the term "educational" as used in § 501(c)(3), relates both to the instruction or training of the individual for the purpose of improving or developing his or her capabilities and instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and it is "substantially related" only if the causal relationship is a substantial one. For the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 85-2, 1985-1 C.B. 178, set forth the following criteria for determining whether an organization's activities lessen the burdens of government: first, whether the governmental unit considers the organization's activities to be its burden; and second, whether these activities actually lessen the burden of the governmental unit. An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances. Rev. Rul. 85-2 held an organization that provides legal advice and training to volunteers who serve as guardian ad litems in juvenile court lessens the burdens of government and is exempt under section 501(c)(3). The juvenile court required the appointment of guardians ad litem. The organization's training of lay volunteers was an integral part of the government's program of providing guardians ad litem. The organization actually was lessening the

government's burden because the government could not continue its present program unless it trained lay volunteers itself or appointed attorneys to act as guardians.

Rev. Rul. 85-1, 1985-1 C.B. 177, held an organization that assisted a county's law enforcement agencies in more effectively policing illegal narcotics traffic lessened the burdens of government and was exempt under section 501(c)(3). The municipality demonstrated that these activities were a part of its burden because the organization funded activities the municipality treats as an integral part of its program to prevent the trafficking of illegal narcotics. The organization actually lessened that burden by enabling the municipality to augment its law enforcement activities in the area of illegal drug traffic without the appropriation of additional governmental funds.

Indiana Crop Improvement Association, Inc. v. Commissioner, 76 T.C. 394, acq., 1981-2 C.B. 1, held an association whose primary activity was the certification of crop seed under State and Federal law was exempt under section 501(c)(3). The association was delegated these functions in accordance with State law. The court concluded the association lessens the burdens of government, finding it "direct assists the U.S. Department of Agriculture in enforcing the standards and procedures established in the regulations under the Federal Seed Act within the State, and provides a public service to Indiana which the State legislature clearly considers to be necessary and appropriate." 76 T.C. at 398-399.

Professional Standards Review Organizations of Queens County v. Commissioner, 74 T.C. 240 (1980), held a professional standards review organization authorized by the Department of Health, Education, and Welfare lessened the burdens of government under section 501(c)(3). Congress authorized the establishment of independent review organizations to advance the important congressional policy of ensuring the effective, efficient, and economical delivery of health care services to Medicare and Medicaid beneficiaries. 74 T.C. at 245. Congress believed the formation of review organizations was "necessary for the Government to make its Medicare and Medicaid programs cost-effective." 74 T.C. at 249. Congress determined it was "preferable and appropriate that organizations of professionals undertake review of members of their profession rather than for Government to assume that role," for which it was "ill equipped." 74 T.C. at 249. The court concluded the organization lessened the burdens of the federal government. 74 T.C. at 251. See Virginia Professional Standards Review Foundation v. Blumenthal, 466 F. Supp. 1164 (D.D.C. 1979), appeal dismissed., Civ. No. 79-1501 (D.C. Cir. 8/13/1979) (Professional standards review organization was exempt under section 501(c)(3) where its principal purposes were to ensure effective and economical delivery of health care services to patients and reduce unnecessary spending on health care programs).

ANALYSIS

Pursuant to HCERA, the U.S. Government discontinued guaranteeing student loans originated under the FFELP. Under the new law, the U.S. Government now makes student loans directly to borrowers, establishing the provision of student loans as the government's burden. See PSRO of Queens County (Implementing Medicare and Medicaid programs was a governmental burden); Indiana Crop (Implementing Federal Seed Act standards and procedures was a governmental burden); Rev. Rul. 85-2 (guardian ad litem program was governmental burden); Rev. Rul. 85-1 (policing illegal narcotics traffic was governmental burden).

HCERA provided that the Secretary of Education may award contracts for servicing the federal direct student loans to eligible non-profit service providers. The statute specifically provided that exemption under section 501(c)(3) is one of the ways to be eligible as a non-profit service provider, along with other requirements. Congress enacted HCERA with the expectation the direct loan program would produce substantial savings for the U.S. Government. It specifically provided for

section 501(c)(3) organizations to service the new federal direct student loans, aware of the unique and valuable role of non-profit service providers to the program and the beneficial assistance they provided to students. See Professional Standards Review Organizations of Queens County, 74 T.C. at 249 (Review organizations were necessary to make Federal programs cost-effective, and the Government was ill-equipped to assume their role); Indiana Crop Improvement Association, 76 T.C. at 398-399 (organization directly assisted the Federal government enforcing regulatory standards and procedures); Rev. Rul. 85-1 (organization's activities were an integral part of governmental program); Rev. Rul. 85-2 (organization's activities were an integral part of governmental program). Therefore, based on all the facts and circumstances, your activities of servicing direct student loans the Department of Education originates under the HCERA further the exempt purpose of lessening the burdens of government.

Ruling #1:

Your activity of servicing student loans the Department of Education originates under the HCERA primarily furthers an exempt purpose under § 501(c)(3).

Ruling #2:

Your activity of servicing direct student loans for the DOE is substantially related to the performance of the functions that constitute the basis of your exemption. Thus, the revenue you generate from this activity will not constitute unrelated business taxable income under §§ 512 and 513.

RULINGS

Based on the foregoing, we rule as follows:

1. Servicing direct student loans originated by the DOE under the HCERA furthers your exempt purposes under § 501(c)(3), and it will not adversely affect your exempt status under § 501(c)(3).

2. The revenue generated from servicing direct student loans originated by the DOE under the HCERA will not constitute unrelated business taxable income under §§ 512 and 513.

This ruling will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.
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.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your 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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager, Exempt Organizations
Technical
Enclosure:
Notice 437

FOOTNOTE

1 The definition for an “eligible not-for-profit servicer” includes an entity “(A) that is not owned or controlled in whole or in part by — (i) a for-profit entity; or (ii) a nonprofit entity having its principal place of business in another State; and (B) that — (i) as of July 1, 2009 — (I) meets the definition of an eligible not-for-profit holder under section 1085(p) of this title . . . and (II) was performing, or had entered into a contract with a third party servicer . . . who was performing, student loan servicing functions for loans made under part B of this subchapter; (ii) notwithstanding clause (i), as of July 1, 2009 — (I) is the sole beneficial owner of a loan for which the special allowance rate is calculated under section 1087-1(b)(2)(I)(vi)(II) of this title because the loan is held by an eligible lender trustee that is an eligible not-for-profit holder as defined under section 1085(p)(1)(D) of this title; and (II) was performing, or had entered into a contract with a third party servicer (as such term is defined in section 1088(c) of this title) who was performing, student loan servicing functions for loans made under part B of this title. . . .” 20 U.S.C. § 1087f(a)(4). An eligible not-for-profit holder is defined as “an eligible lender under subsection (d) . . . that is — (A) a State, or a political subdivision, authority, agency, or other instrumentality thereof, including such entities that are eligible to issue bonds described in section 1.103-1 of Title 26, Code of Federal Regulations, or section 144(b) of Title 26; (B) an entity described in section 150(d)(2) of such title that has not made the election described in section 150(d)(3) of such title; (C) an entity described in section 501(c)(3) of such title; or (D) acting as a trustee on behalf of a State, political subdivision, authority, agency, instrumentality, or other entity described in subparagraph (A), (B), or (C), regardless of whether such State, political subdivision, authority, agency, instrumentality, or other entity is an eligible lender under subsection (d).” 20 U.S.C. § 1085(p).

END OF FOOTNOTE