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

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Date: FEB 18 2000

Contact Person:

ID Number:

Telephone Number:

OP:E:EO:T4

Employer Identification Number:

Legend:

M =
P =
R =

Dear Sir or Madam:

This is in reference to M's request in a letter dated May 21, 1998, for rulings concerning the federal income tax consequences of M's transfer of obligations and the assets that secure them to a for-profit entity pursuant to section 150(d)(3) of the Internal Revenue Code. M requests the following rulings:

1. M's change in activities, purpose, and governance, as described in its request, will not adversely affect its qualification as an organization exempt under section 501(c)(3) of the Code.

2. M qualifies as an organization described in section 509(a)(3) of the Code.

3. M's conduct of the activities described in its request will not constitute an unrelated trade or business under section 513 of the Code.

Facts:

M is a P nonprofit corporation organized for the purpose of providing a secondary market for the acquisition of student loan notes incurred under the Higher Education Act of 1965, as amended. M has been recognized by the Internal Revenue Service (the "Service") as exempt from federal income tax under section 501(a) of the Code by reason of being described in section 501(c)(3) of the Code. M has received a final determination classifying it as other than a private foundation under section 509(a)(2) of the Code.

M has made an election under section 150(d)(3) of the Code so that it may devote its assets and income to a broader spectrum of educational support than it may permissibly conduct as an organization qualified under section 150(d)(2) of the Code. Pursuant to the election, M transferred all of its student loan notes and other assets pledged to secure repayment of its qualified scholarship funding bond indebtedness to a newly formed subsidiary. M has also represented that it took all the other actions required under section 150(d)(3)(B) and (C) of the Code. These actions include the change in M's purpose and activities as

330

required under section 150(d)(3)(C), so that it will no longer constitute an organization described in section 150(d)(2), but will remain a charitable organization under section 501(c)(3).

M represents that it will no longer operate exclusively for the purpose of acquiring student loan notes. Instead, M intends to provide a variety of educational programs and services in P, including the following:

1. Grants, loans and other financial assistance to students, publicly supported colleges, universities and other educational institutions.

2. Training programs for students, student counselors and parents who seek information about the availability of financial aid programs.

3. Assistance to colleges and universities in interpreting, compiling and filing required data.

4. Other forms of assistance to students, parents, and educational institutions, directly, or through programs conducted by educational institutions, student loan lenders and student loan holders.

M also intends to provide financial assistance to programs directed toward creating and improving the job opportunities of low income residents of R County.

M has amended its Articles of Incorporation ("Restated Articles") and by-laws to reflect its revised charitable purposes. M's Restated Articles sets forth in part the following purposes clause:

> The Corporation is organized and shall be operated to benefit and carry out the purposes of the State through financial aid and other assistance to students and to publicly supported schools, colleges, universities and other educational institutions located in P, and through financial aid and other assistance to programs directed to the reduction of underemployment and unemployment among low income residents of R.

The Restated Articles also provide that the Directors of M's Board of Directors shall be appointed by and vacancies shall be filled by the Governor of the State of P.

Law:

Section 501(a) of the Code provides for exemption from federal income taxes for organizations that are described in section 501(c)(3).

Section 501(c)(3) of the Code provides, in part, that an organization is exempt from Federal income tax if it is organized and operated for charitable and educational purposes, and if no part of the net earnings of the organization inures to the benefit of any private shareholder or individual, and if no substantial part of its activities is carrying on propaganda or otherwise attempting to influence legislation, and if it does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Section 509(a) of the Code provides that the term "private foundation" means an organization described in section 501(c)(3) other than certain organizations described in section 509(a)(1), (2), (3), or (4).

Section 509(a)(3) of the Code describes an organization which-

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2),

(B) is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2), and

(C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2).

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

Section 513(a) of the Code provides, in part, 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 of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, with certain exceptions.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in that 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, in part, that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such purposes described in section 501(c)(3) of the Code, but 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)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more section 501(c)(3) purposes unless it serves a public rather than a private interest. An organization must, therefore, show that it is not organized or operated for the benefit of private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides a definition of the term "charitable" as it is used in section 501(c)(3). The regulation provides that the term "charitable" is used in its generally accepted legal sense. The term includes both advancement of education and lessening the burdens of government.

Section 1.509(a)-4(c)(1) of the Income Tax Regulations provides that an organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in section 1.501(c)(3)-1(b)(2)):

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Section 1.509(a)-4(d)(1) of the regulations provides that in order to meet the requirements of section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more "specified" publicly supported organizations.

Section 1.509(a)-4(d)(2)(i) of the regulations provides that, except as provided in subdivision (iv) of this subparagraph, in order to meet the requirements of subparagraph (1) of this paragraph, the articles of the supporting organization must designate each of the "specified" organizations by name unless:

(a) The supporting organization is operated, supervised, or controlled by (within the meaning of paragraph (g) of this section), or is supervised or controlled in connection with (within the meaning of paragraph (h) of this section) one or more publicly supported organizations; and

(b) The articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose and which include:

(1) The publicly supported organizations referred to in (a) of this subdivision (without designating such organizations by name); or

(2) Publicly supported organizations which are closely related in purpose or function to those publicly supported organizations referred to in subdivision (i)(a) or this subparagraph (without designating such organization by name).

Section 1.509(a)-4(e)(1) of the regulations provides that a supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations (hereinafter referred to as the "operational test") only if it engages solely in activities which support or benefit the specified publicly supported organizations.

Section 1.509(a)-4(f)(1) of the regulations provides that section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations.

Section 1.509(a)-4(g)(1)(i) of the regulations provides that each of the items "operated by," "supervised by," and "controlled by," as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

Section 1.509(a)-4(j)(1) of the regulations provides, in part, under the provisions of section 509(a)(3)(C), a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship

between the business activities which generate the particular income in question (the activities, that is, of producing or distributing the goods or performing the services involved) and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides, in part, that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one.

Rationale and Conclusion:

The information provided indicates that M has been organized and, after its election and transfer, continues to be operated exclusively for charitable and educational purposes, by providing various educational and financial assistance programs and activities. See section 1.501(c)(3)-1(d)(2) of the regulations. Furthermore, based on M's representation that it has met all of the requirements of section 150(d)(3) of the Code with respect to its proposed election to cease its status as a qualified scholarship funding corporation, we conclude that M's change in activities, purpose and governance will not adversely affect M's accomplishing exclusively charitable purposes.

The information provided also indicates that M is described in section 509(a)(3) of the Code. M is organized and operated exclusively for one or more purposes specified in section 509(a)(3)(A). M has represented that it will engage exclusively in activities which support or benefit publicly supported organizations. M's Board of Directors are appointed by the Governor of the State of P and the organizations supported by M are related by both purpose and function to the State of P. See Restated Articles and sections 1.509(a)-4(c)(1), 1.509-4(d)(2), and 1.509(a)-4(e)(1) of the regulations.

M also meets the requirements of section 509(a)(3)(B) since it is operated, supervised, and controlled by the State of P. The relationship between M and the State of P is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. See section 1.509(a)-4(g) of the regulations.

Based on M's representation that it will not be controlled, directly or indirectly, by one or more disqualified persons other than foundation managers and publicly supported organizations, we conclude that M meets the requirements of section 509(a)(3)(C).

The information also indicates that M intends to provide a variety of educational programs and services that are substantially related to M's exempt purposes. See section 1.513-1(d)(2) of the regulations. Therefore, we conclude that M's proposed activities will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code.

Accordingly, based on all the facts and circumstances described above, we rule, as follows:

1. M's change in activities, purpose, and governance, as described above, will not adversely affect its qualification as an organization exempt under section 501(c)(3) of the Code.

2. M qualifies and is reclassified as an organization described in section 509(a)(3) of the Code.

3. M's conduct of the activities described above will not constitute an unrelated trade or business under section 513(a) of the Code.

The ruling in this letter only applies the specifically indicated sections of the Code and regulations to the facts that M has presented. In this letter, we do not rule on fair market value or the applicability of section 4958 taxes on excess benefit transactions or any other sections of the Code and regulations to your case.

This ruling is directed to M only. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Group 4