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

Date: JUN 29 2000

Contact Person:

ID Number:

Telephone Number:

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LEDGEND:

"M" -
"N" -

Dear Sir or Madam:

This is in response to your request, dated April 5, 2000, and amended on June 28, 2000, for rulings concerning the election to cease status as a qualified scholarship funding corporation (QSFC) for the purposes of section 150(d) of the Internal Revenue Code, and the federal income tax consequences of your transfer of obligations and assets that secure them to a for-profit entity pursuant to section 150(d)(3).

FACTS:

You were incorporated in 1983 and recognized as a tax-exempt organization described in section 501 (c)(3) of the Code and as other than a private foundation under section 509(a)(3) on October 3, 1983.

You are the designated secondary market in the State for student loans originated under the Higher Education Act and, as such, are a QSFC within the meaning of section 150(d) of the code. Your Articles of Incorporation, as amended, provide that you are organized exclusively to promote and carry out the charitable and educational objectives of the State embodied in the State Guaranteed Student and Parental Loan Programs, by encouraging lenders to make educational loans under the Higher Education act through your creation and operation of a secondary market which will provide liquidity for investments in such loans. As a QSFC, you issue bonds and notes and apply the proceeds of the sale to the payment of the costs of acquiring the student loan notes.

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Prior to January 1, 1993, you employed approximately 20 persons. Effective January 1, 1993, you entered into a Purchase of Services Contract with "M" to provide you administrative services. All of your employees ended their employment with you and became employees of "M." You currently employ only one person, your president.

"M" was formed in 1992, and recognized as a tax-exempt organization described in section 501 (c)(3) of the Code. "M" is organized exclusively for educational and charitable purposes. "M's" Board of Directors consists of seven members, three of whom are also members of your Board of Directors. None of the other directors of "M" have a present relationship with you. Neither "M's" articles or by-laws nor your articles or by-laws require overlapping directors.

Your president currently serves as an ex officio member of the Board of Directors of "N." "N" is a statutorily created instrumentality of the State authorized to perform secondary market and related education finance activities for educational loan programs other than programs undertaken pursuant to Title IV of the Higher Education Act. These programs include non-federally authorized, non-federally insured student loan programs, and the Health Education Assistance Loan Program authorized under the Federal Health Service Act. Members of "N's" Board are determined by statute. Pursuant to recently proposed legislation your president will no longer serve as an ex officio member of "N's" Board.

You are contemplating the proposed election pursuant to section 150(d)(3) of the Code to terminate your status as a QSFC while continuing to qualify as a tax exempt charitable organization under section 501(c)(3). Following the election you will maintain your status as a tax-exempt organization described in section 501(c)(3) by engaging in a variety of charitable programs and activities. You will maintain an independent community board of directors as defined in section 150(d)(3)(E) and will own all of the "senior stock" and the common stock of the Transferee. You will have the right to require redemption of the "senior stock" within ten years of the proposed election, as required by section 150(d)(3). Following the proposed election, you contemplate that you will cause the "senior stock" to be redeemed at fair market value as provided for under section 150(d)(3). You also contemplate that the common stock, if any, will be redeemed or otherwise sold or transferred at fair market value following the proposed election. Your Articles of Incorporation and by-laws will be amended by your Board following the proposed election.

You intend to employ your own personnel to conduct your charitable activities after the proposed election and will either terminate or otherwise assign your rights under the Purchase of Services Contract. You also expect that your Board and "M's" Boards will be independent, with no overlapping members. You will continue to be organized and operated exclusively for charitable and educational purposes through your funding

and/or carrying out of a variety of educational programs and activities. These programs and activities may include: (i) scholarship and/or grant programs; (ii) providing counseling and guidance to parents, students, lenders, and schools in a wide variety of matters concerning higher education and career planning; (iii) making available computer software programs to parents and students that provide information relating to the availability of financial aid for higher education and that allow students to submit applications to colleges and universities through electronic transmission; (iv) providing housing, books, and other educational related items to qualified students who would otherwise have to discontinue their education; (v) providing internship programs that would allow students to gain experience and provide charitable services to the community; (vi) provide funding for qualified students for study in foreign countries; and, (ix) provide educational programs for young persons aimed at the prevention of juvenile delinquency.

RULINGS REQUESTED:

You specifically requested the following:

1. The proposed activities, operations, and programs to be instituted and performed by you following the proposed election, including the ownership and subsequent redemption or sale of the "senior stock" pursuant to section 150(d)(3) of the Code (and the common stock, if any), and the charitable and educational programs and activities described, will not affect your current exempt status under section 501(c)(3).

2. Your ownership and subsequent redemption and sale of the "senior stock" pursuant to section 150(d)(3) of the Code (and the common stock, if any), and the charitable and educational programs and activities described, will not constitute unrelated business income to you under section 511.

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 sections 509(a)(1), (2), (3), or (4).

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

Section 512(a)(1) of the Code provides that, except as otherwise provided in this subsection, 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) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(1) of the Code provides, in part, that there shall be excluded from the definition of unrelated business taxable income all dividends, interest, payments with respect to securities deductions loans (as defined in section 512(a)(5)), and annuities, and all directly connected with such income paid to an exempt organization.

Section 512(b)(5) of the Code provides, in part, that there shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than--

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

Section 4958(a)(1) of the Code imposes on each excess benefit transaction a tax equal to 25 percent of the excess benefit. Any disqualified person referred to in subsection (f)(1) with respect to such transaction shall pay the tax imposed by this paragraph.

Section 4958(a)(2) of the Code imposes, in any case in which a tax is imposed by section 4958(a)(1), a tax equal to 10 percent of the excess benefit on the participation of any organization manager in the excess benefit transaction knowing that it is such a transaction unless such participation is not willful and is due to reasonable cause. Any organization manager who participated in the excess benefit transaction shall pay the tax imposed by this paragraph.

Section 4958(b) of the Code imposes a tax equal to 200 percent of the excess benefit involved in any case in which an initial tax is imposed by section 4958(a)(1) on an excess benefit transaction and the excess benefit involved in such transaction is not corrected within the taxable period.

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)-l(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)-3(m)(1) of the regulations provides, in part, that, for purposes of section 509(a)(2), where the charitable purpose of an organization described in section 501(c)(3) is accomplished through the furnishing of facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from such persons will be considered "gross receipts" (within the meaning of section 509(d)(2)) from an activity which is not an unrelated trade or business, rather than "gross investment income."

RATIONALE:

Section 150(d)(3)(A) of the Code states that if a QSFC's election and transfers under section 150(d)(3) meet all the requirements of section 150(d)(3), then the QSFC will cease to be a QSFC as described in section 150(d)(2) without affecting the tax-

exempt status of any of its outstanding tax-exempt obligations. Section 150(d)(3)(C)(i) requires that a QSFC making the election and transfers described in section 150(d)(3) must continue to exist as an organization described in section 501(c)(3) of the Code. Eighty percent (80%) of the members of the QSFC's board of directors must be independent members as defined in section 150(d)(3)(E). The electing QSFC must own the senior stock of the Transferee.

Pursuant to section 150(d)(3)(B)(v) of the Code, it is required that the Transferee not be exempt under this chapter. Section 150(d)(3)(F) states that the Transferee will be a functionally related business to the electing QSFC (within the meaning of section 4942(j)(4) of the Code). Therefore, Code section 4942 and 4943 do not apply to the electing QSFC and the QSFC will not be required to divest its holding in the Transferee during the period beginning on the date of the QSFC's election under 150(d)(3) and ending the date that is the earlier of (i) the last day of the last taxable year for which more than fifty percent (50%) of the gross income of which transferee corporation is derived from, or more than fifty percent (50%) of the assets (by value) of the Transferee consists of, student loan notes incurred under the Higher Education Act of 19665; or, (ii) the last day of the taxable year of the electing QSFC during which occurs the date which is 10 years after the date on which the election under section 150(d)(3) is made.

Based upon the information provided, after the proposed election and transfer you will continue to operate exclusively for charitable purposes. You will provide various charitable and educational related programs and activities. These programs and activities provide instruction and training to individuals and to the general public. A number of the programs and activities will be designed to provide educational opportunities to individuals who could not otherwise afford them. Accordingly, your purposes and proposed activities, operations and programs following the proposed election will not affect your exempt status under section 501(c)(3) of the Code. Furthermore, assuming that you meet all the requirements of section 150(d)(3) with respect to the proposed election to cease your status as a QSFC, your ownership of the Transferee's "senior stock" and the stock's subsequent redemption will not adversely affect your accomplishing exclusively charitable purposes.

The transfer of your assets to the Transferee in exchange of the "senior stock", as well as the subsequent redemption or sale of the stock, will constitute a one time sale of a principal asset. Therefore, we also conclude that the modifications of section 512(b)(1) and 512(b)(5) apply in this instance to exclude "senior stock" dividends and gains and losses from the transfer and redemption of the stock from unrelated business taxable income under section 511 of the Code.

CONCLUSION:

Based on all the facts and circumstances, we rule as follows:

1. The proposed activities, operations, and programs to be instituted and performed by you following the proposed election, including the ownership and subsequent redemption or sale of the "senior stock" pursuant to section 150(d) of the Code (and the common stock, if any), and the charitable and educational programs and activities described, will not affect your current exempt status under section 501(c)(3).

2. Your ownership and subsequent redemption and sale of the "senior stock" pursuant to section 150(d)(3) of the Code (and the common stock, if any), and the charitable and educational programs and activities described, will not constitute unrelated business income to you under section 511.

The rulings in this letter apply specifically to the indicated sections of the Code and regulations and to the facts you have presented. In this letter we do not rule on the applicability of section 4958 of the Code or any other sections of the Code and regulations to your case.

In this letter we are not determining whether any future proposed activity is an unrelated trade or business as defined in section 513 of the Code. We are also not considering whether or not you will be a private foundation after the proposed election or whether your grant making will meet the requirements of section 4945 of the Code. If changes in your sources of revenue after the proposed election and transfer of assets cause you to become a private foundation, you should notify the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service and request a ruling on your grant making procedures. The mailing address is: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code states that it may not be used or cited as precedent. Because

this letter could help resolve questions you should keep this copy in your permanent records.

Sincerely yours,

Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Group 4