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TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

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

Date: AUG 15 2003

Contact Person:

Identification Number:

Telephone Number:

T:EO:BR4

Employer Identification Number:

Legend:

B:
C:
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E:
x:
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Dear Taxpayer:

We have considered B's ruling request dated February 6, 2003, along with supplemental correspondence, concerning the application of the unrelated business tax provisions to B's proposed student loan and securitization activities.

Facts

B is a nonprofit corporation formed by C. B is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code, and is classified as a supporting organization of C under section 509(a)(3). B is a nonstock corporation without members. B is governed by a five-person board of directors appointed by resolution of C's Executive Committee. If the C Executive Committee fails to appoint directors, the D of E has the power to appoint the directors. C's Executive Committee may remove any director of B, with or without cause, at any time by a majority vote of the Executive Committee of C.

The Articles provide that B is organized exclusively for charitable purposes. Specifically, its sole activity will be:

> to carry out student loan securitization transactions for the benefit of, or to carry out the purposes of. . .C. . ., by, from time to time, incurring indebtedness through issuing and conveying notes or other obligations pursuant to an indenture, as amended or supplemented from time to time. . . ., and using substantially all of the proceeds to purchase student loans and certain student loan assets directly or indirectly from C . . ., and taking such other actions as the Board of Directors determines may be incident, reasonable or appropriate to accomplish securitization of such Student Loan Assets, in a manner that is intended to lessen C's burden of accessing the funds required to accomplish one or more of its governmental purposes.

Under the Bylaws, B is authorized to distribute income or assets to C exclusively for C's public purposes. It is the intention of B that to the extent income or assets of B are not required for purposes of the securitizations, they will be distributed to C. Moreover, upon dissolution of B, all of the assets of B are to be transferred back to C exclusively for public purposes.

C was created and controlled by E to improve higher educational opportunities of its residents and persons who are attending approved institutions of higher education in E and elsewhere. Pursuant to the programs that the Legislature created C to administer, C makes grants to students, makes student loans with no or discounted points and at subsidized interest rates, and forgives certain student loans. In addition, C spends millions of dollars each year educating students and parents about higher educational opportunities and financial aid, and provides direct financial assistance to certain institutions of higher education within E. C is the designated student loan guarantee agency for purposes of the United States Higher Education Act. C's enabling legislation also directs that C use its resources to enable other lenders and post secondary institutions to make student loans.

C also has a statutory mission to provide a secondary market for any lender who makes student loans to E residents and others who attend qualified institutions. Like other markets, the secondary market for student loans is cyclical. At times many entities, including C, compete to buy student loan portfolios on competitive terms. At other times the market for student loans is tight and lenders cannot sell loans on favorable terms, which cause such lenders to become hesitant to originate new loans. By providing a secondary market on reasonable terms, regardless of market conditions, C satisfies its statutory directive to enable other lenders to make student loans available.

B, or a disregarded entity B creates, will retain and invest, in one or more accounts: the remaining portion of the funds advanced by Certificate holders, cash flows from student loans acquired in the transaction, and earnings on B's deposits and assets in one or more accounts. Maintenance of such accounts will be necessary to hold B's operating funds and will enable B to assure timely payments to Certificate holders and, therefore, to secure desired ratings from nationally recognized rating agencies on the Certificates. Obtaining such ratings will lower the interest rates on the Certificates and help ensure that the Certificates are marketable on terms that make the transaction financially beneficial to C, thereby lessening C's burden to access funds necessary to make or purchase additional student loans at rates favorable to students.

As part of a typical transaction, generally B or the wholly-owned disregarded entity will (a)

pledge each pool of student loan assets and any related account(s) as collateral security for the payment of all principal of and interest on all or part of the related Series of Certificates, and (b) retain a residual interest in each pool of student loans and the related account(s). B intends to distribute to C, from time to time, all of the cash flows, net of payments to Certificate holders, from each pool of student loans and the related account(s).

C intends to present the securitization structure described in this ruling, including B's participation, to the Office of the Attorney General of E for review prior to C's initial transfer of loans to B. The Office of the Attorney General also will review for form and legality all material contracts C enters into in connection with a securitization.

Ultimately, the securitizations will benefit students of E. C will use additional liquidity generated by the securitizations to meet its statutory mandate to make loans to students and participate with other eligible lenders in making loans available to students (by providing a secondary market to those lenders). C and its participating lenders will, thus, continue to have funds available to make discounted loans to students.

Rulings Requested

B requests rulings:

1. That income from B's securitization transactions is not unrelated business taxable income under sections 511-514 of the Code because all of B's activities are substantially related to its exempt purpose as provided in section 513(a) of the Internal Revenue Code of the Code.

2. That income from B's securitization transaction is not unrelated business income because any debt incurred in securitization transactions will be exempt purpose debt under section 514(c)(4) of the Code.

3. That income from B's securitization transactions is not unrelated business taxable income under Code sections 511-514 because B's use of property acquired with borrowed funds or accounts funded with borrowed funds will be substantially related to performance of its exempt function as provided in section 514(b)(1)(A) of the Code.

4. That interest and/or dividends earned on securitization accounts funded with exempt purpose operating revenues (cash flows from student loans and investment earnings) are not unrelated business taxable income pursuant to Section 512(b)(1)(A) of the Code.

Law

Section 511(a) of the Code imposes tax on the unrelated business income of certain organizations that are otherwise exempt from tax under Section 501(a) of the Code.

Section 512 of the Code defines unrelated business taxable income, in part, as gross income derived by an organization from any unrelated trade or business regularly carried on by it.

Section 512(b) of the Code provide that interest payments are excluded from the definition of unrelated business taxable income, except in the case of debt financed property as defined in section 514.

Section 513(a) of the Code defines an unrelated trade or business as any trade or business tile conduct of which is not substantially related to the exercise or performance of the purpose for which the organization was granted exemption.

Section 1.513-1(a) of the Income Tax Regulations; provides, in part, that the exempt organization is generally subject to tax on income from unrelated business activities if the following three conditions are present:

(a) The organization is subject to tax under Code section 511;
(b) The income is from a trade or business which is regularly carried by the organization, and
(c) The conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is related to exempt purposes where the conduct of the business activities has a causal relationship to the achievement of exempt purposes. It is substantially related if the casual relationship is substantial. The relationship is substantial if the activity contributes importantly to the accomplishment of exempt imposes. Whether activities productive of gross income contribute importantly to the accomplishment of an exempt purpose depends in each case upon the facts and circumstances involved.

Section 514(a) of the Code provides, in relevant part, for the taxation of income derived from debt financed property.

Section 514(b) of the Code defines the term" debt financed property" to mean any property that is held to produce income with respect to which there is an "acquisition indebtedness" (as defined in section 514(c)).

Section 514(b)(1)(A)(i) of the Code excludes from the definition "debt financed property" any property substantially all of the use of which is substantially related (aside from the need of the organization for income or funds) to the organization's exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501.

Section 514(c)(1) of the Code defines the term "acquisition indebtedness" to mean, with respect to any debt financed property, the unpaid amount of the indebtedness incurred by the organization in acquiring such property.

Section 514(c)(4) of the Code provides that the term "acquisition indebtedness" does not include indebtedness the incurrence of which is inherent in the performance or exercise of the

purpose or function constituting the basis of the organization's exemption.

Section 1.514(b)-1(b)(1) of the regulations provides that the principles of section 1.513-1 of the regulations are to be used to determine whether there is a substantial relationship to the exempt purpose of the organization.

In Rev. Rul. 79-122, 1979-1 C.B. 204, the qualified trust of a leveraged employee stock ownership plan ("ESOP") under section 4975(e)(7) purchased employer securities with borrowed funds. The Service ruled that the leveraged ESOP's capital growth and employee stock ownership objectives were a part of its exempt function and that borrowing to purchase employer securities is an integral part of accomplishing those objectives.

Analysis

An organization is generally subject to the unrelated business income tax if the organization is subject to tax under section 511, the income is from a trade or business which is regularly carried on, and the conduct of such trade or business is not substantially related to the organization's performance of its exempt function.

B is recognized as exempt from income tax under section 501(c)(3) of the Code and is subject to the tax under section 511 of the Code. Additionally, the securitization of loans and bundling for sale on the secondary market is a trade or business. B's primary activity is to carry out student loan securitization transactions. B intends to conduct this activity on an ongoing and regular basis. As such, the income received by B is income from a trade or business which is regularly carried on by B.

However, in order for B's income not to be considered taxable, B's student loan securitization activities must be substantially related to B's performance of its exempt function. B conducts student loan securitization transactions to provide a source of capital and additional flexibility to C and C's program of improving higher educational opportunities for students in E. B was created and is controlled by C, its supported organization, and is operated to further C's charitable purposes. B's student loan securitization activities are substantially related to its exempt purpose. Therefore, income from B's student loan securitization activities is not subject to unrelated business income tax.

B's investment in student loans is substantially related to its charitable function. Section 514(b)(1)(A)(i) of the Code and section 1.513-1(d)(2) of the regulations provide that any property used that is substantially related to an organization's exempt function is excepted from the definition of debt finance property. Therefore, student loans are not debt financed property and income derived from the student loans is not taxable unrelated business income.

Income from B's funds and accounts is not unrelated business taxable income. B's choice to incur debt in the securitization transactions is merely the vehicle to accomplish its exempt purpose. As such, the indebtedness is not acquisition indebtedness. Earnings on Series Proceeds held in such funds and accounts are not debt financed income.

Moreover, there is a causal relationship, between B's maintenance of such funds and accounts and the achievement of its exempt purpose of generating liquidity necessary for C to accomplish its statutory mission. Specifically, B uses such funds to acquire loans from C simultaneously with the sale of Certificates, and to subsequently acquire additional student loans as is required to meet collateralization requirements or other terms of each securitization transaction. Such funds will also allow B to meet operating expense and ensure timely payment of obligations to Certificate holders. This will enable B to secure ratings necessary to lower interest rates on Certificates. Accordingly, the causal relationship between B's maintenance of its various funds and the achievement of B's exempt purpose is important to the accomplishment of such purpose as provided in section 1.513-1(d)(2) of the regulations.

Finally, pursuant to section 512(b)(1)(a) of the Code, interest or dividend earnings from accounts or funds holding operating revenues other than Series Proceeds will not be unrelated business taxable income. For the reasons discussed above, such interest and dividends are substantially related to B's performance of its exempt educational purpose.

Rulings

Based upon the information that you have submitted, under the facts described above:

1. Income from B's securitization transactions is not unrelated business taxable income under sections 511-514 of the Code because all of B's activities are substantially related to its exempt purpose as provided in section 513(a) of the Code.

2. Income from B's securitization transaction is not unrelated business income because any debt incurred in securitization transactions will be exempt purpose debt under section 514(c)(4) of the Code.

3. Income from B's securitization transactions is not unrelated business taxable income under Code sections 511-514 because B's use of property acquired with borrowed funds or accounts funded with borrowed funds will be substantially related to performance of its exempt function as provided in section 514(b)(1)(A) of the Code.

4. Interest and/or dividends earned on securitization accounts funded with exempt purpose operating revenues (cash flows from student loans and investment earnings) are not unrelated business taxable income pursuant to Section 512(b)(1)(A) of the Code.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Internal Revenue Code.

Because this ruling could help resolve future questions about your federal income tax liabilities, you should keep it in your permanent records.

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 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.

Sincerely,

Debra J. Kawecki

Debra J. Kawecki
Acting Manager
Exempt Organizations
Technical Group 4