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INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

UIL: 501.00-00
511.00-00

October 31, 2006

Area Manager –

Taxpayer's Name:
Taxpayer's Address

Taxpayer's Identification Number:

Years Involved:

Conference Held:

Legend

T =

Issues

Whether funds derived by T, a state-chartered credit union described in section 501(c)(14) of the Internal Revenue Code, from the sale of credit life and credit disability insurance should be treated as unrelated business taxable income under section 511 of the Internal Revenue Code.

Facts

Established in 1951, T is a state-chartered credit union, which is recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code ("Code") as an organization described in section 501(c)(14)(A).

T's board of directors, supervisory committee and loan committee are comprised entirely of elected members of the credit union who serve on a voluntary basis without compensation.

T's purposes as stated in its articles of incorporation are to promote thrift and provide low cost credit for its members.

T's activities include accepting deposits from and maintaining the accounts and savings of its members. These deposit accounts include savings or share accounts on which members earn periodic dividends credited to the accounts and share draft accounts, which are transaction accounts similar to bank checking accounts. T represents that its day-to-day business operations differ from conventional banking institutions in several ways. T states that it conducts its business to reflect its non-profit mutual structure. T makes loans to its members and states that many borrowers have low incomes and might not otherwise qualify for credit from conventional for-profit banks. T also represents that it regularly issues loans for very small amounts, such as loans for auto repairs, which are typically not made by for-profit banks. T indicates that it serves smaller communities than those served by for-profit banks. T also indicates that because of its mutual, non-profit operation, all members, not just those maintaining high minimum balances, are able to earn competitive rates on their deposits and pay low banking fees.

T represents that in order to maintain its financial viability and continue to satisfy its stated purposes of promoting thrift and providing a source of low cost credit, it has endeavored to become a full service financial institution. Consequently, T offers more than just demand deposits and loans. Currently, T makes credit life and credit disability insurance available to members. The credit insurance is described in more detail below.

All of these insurance products are underwritten or otherwise provided by third-party insurance companies or other third-party vendors. In each case, T makes its members aware of the purpose and availability of these products, answers members' questions about the products or refers the member to the vendor for additional information, and with respect to some of the products, obtains and submits applications for coverage, premium payments and claims.

During the year at issue, T made the following types of loans: personal, mortgage, vehicle, and other secured and unsecured loans. The majority of the loans were personal, mortgage and vehicle. In 2000, a total of 237 loans were made and approximately 20% of these loans were collateralized.

No information was provided regarding the default rate on these loans as a percentage of total loans for the year at issue.

T filed Form 990-T, Unrelated Business Income Tax Return for the year at issue. However, the amounts derived from the sale of the products discussed herein were not included as income derived from unrelated trade or business.

Sale of credit life and credit disability insurance

T offers its member/borrowers the opportunity to purchase credit life and credit disability insurance on certain loans. T is a party to, and beneficiary under, standard group credit life and credit disability policies with a third party insurance company. Under these policies, a member-borrower who obtains a loan (mortgages and other loans secured by real estate are often excluded) may, if he or she chooses, obtain credit life and credit disability insurance which pays the loan installments during the period of physical disability which impacts the borrower's employment. A loan officer informs each member-borrower of the availability of credit life and credit disability insurance coverage, and if the member-borrower elects to obtain the coverage, the premium charge is added to the borrower's loan balance. Obtaining the credit life and credit disability insurance coverage is never a condition of the member's receiving the loan.

As reflected in the group credit insurance policy and letter agreements, the credit disability coverage is standard coverage that provides that the insurer will repay the balance of a member's loan up to the policy limit. The maximum loan duration covered was 120 months and the maximum amount of loan insured was $30,000. T does not offer credit life and credit disability insurance in connection with overdraft protection, home equity loans, and real estate loans.

Under the terms of the policy, T is also reimbursed for its administrative expenses in connection with its performance of the prescribed duties as the policyholder. T's employees perform the following duties with respect to the credit disability insurance program:

- During the loan process, and as part of the loan transaction itself, explain the insurance program to member-borrowers;
- Process insurance applications;
- Collect and forward the premiums to the insurance company;
- Receive and forward claims (claims can be filed directly by the member-borrower) to the insurance company; and
- Answer member-borrowers' questions.

T's staff may recommend that the member opt to obtain coverage in situations where coverage appears beneficial based on the level of personal and family resources available for loan repayment in the event of disability.

The credit disability insurance coverage requires monthly premium payments. The charges are calculated by T and added to the member's loan

balance. T remits the premiums it has collected, less its expenses as noted above, to the insurance company.

T's commission for its role in coverage issuance and policy administration is 4.5% of the net monthly premiums for credit life and credit disability insurance. This percentage is based on an agreement between T and the insurance company at the time the insurance was purchased.

Approximately 63% of borrowers opted for credit insurance during the year at issue.

Law

Section 501(a) of the Internal Revenue Code ("Code") provides, in part, that organizations described in section 501(c) are exempt from federal income tax.

Section 501(c)(14)(A) of the Code specifically exempts from federal income tax credit unions without capital stock organized and operated for mutual purposes and without profit.

Section 1.501(c)(14)-1 of the Income Tax Regulations ("regulations") provides, in part, that credit unions (other than Federal credit unions described in section 501(c)(1) of the Code) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501(a).

State-chartered credit unions were first acknowledged as exempt from federal income tax in a 1917 Opinion of the Attorney General. The Attorney General considered credit unions organized under the laws of the Commonwealth of The Attorney General's opinion described the purposes of credit unions existing at that time:

> [I]t is apparent that the purpose of these financial associations is to help people save and to assist those in need of financial help whose credit may not be established at the larger banks. In reality, they are fundamentally similar and supplemental to the existing agencies for promoting thrift, namely, the savings banks and cooperative banks, except on a much smaller scale.

The Attorney General's opinion also described some of the operations of credit unions--making loans in appropriate amounts to members, "on which a low rate of interest is charged," and that "[p]rompt payment of obligations is a fundamental requirement..." The opinion described in detail the procedures by which members' savings were held by the credit union, and how the members earned interest on their deposits. The opinion also pointed to the democratic character of the governance of these early credit unions by their members: "At

the annual meeting of the association each member (shareholder and depositor) has but one vote..."

After review of the features and operations of these early credit unions, the Attorney General's opinion held that state-chartered credit unions would be exempt from federal income tax. *See* 31 U.S. Op. Atty. Gen. 176 (1917).

The legal analysis of the Attorney General's 1917 opinion was adopted in Treasury regulations issued in 1918, and this remained the official basis for the tax exempt status of state-chartered credit unions until the Revenue Act of 1951 granted express statutory tax-exempt status to state-chartered credit unions. However, the Revenue Act of 1951 removed tax exemption from savings and loan associations, cooperative banks, and mutual savings banks. The legislative history of the act suggests that the reason these entities lost their exemption was because of their increasing similarity to commercial banks and the resulting loss of their original characteristic of mutuality. Specifically referring to the early days of these institutions, the legislative history states:

> "The fact that the members were both the borrowers and the lenders was the essence of the "mutuality" of these organizations." *See generally* S. Rep. No. 781 (Sept. 18, 1951), *reprinted in* U.S. CODE CONG. & AD. SVC. 1969, 1991-97.

Present-day section 501(c)(14)(A) – as enacted in 1951 – incorporates the requirements of mutuality and non-profit operation which formed the basis for the Attorney General's recognition of credit unions' tax-exempt status in 1917. Accordingly, the basic purposes of the credit union tax exemption remain essentially the same today as they were in 1917. Based on the Attorney General's opinion, the basis for exemption is the provision of savings accounts and loans to members who may not be served by banks in a non-profit and mutual manner.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations otherwise exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means, with certain modifications, the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions.

Section 513(a) of the Code defines the term "unrelated trade or business" in the case of any organization subject to tax imposed by section 511, as any trade or business the conduct of which is not substantially related (aside from the need of such organization for the income or funds or the use it makes of the profits

derived) to the exercise or performance by such organization of its exempt function.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is, with certain exceptions, includable in the computation of unrelated business taxable income if (1) it is income from trade or business, (2) such trade or business is regularly carried on by the organization, and (3) 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(b) of the regulations provides that the term "trade or business" has the same meaning it has in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(c)(1) of the regulations states that in determining whether a trade or business is "regularly carried on" within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities are conducted and the manner in which they are pursued. Hence, for example, specific business activities will ordinarily be deemed "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

Section 1.513-1(d)(1) of the regulations provides that gross income is derived from "unrelated trade or business" within the meaning of section 513(a) of the Code, 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 that 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 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 (other than through the production of income), and it is "substantially related," for purposes of section 513, only if the causal relationship is a strong one. Thus, for the conduct of a 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 the services from which the gross income is derived must contribute importantly to the accomplishment of those exempt purposes. Whether activities contribute importantly to an organization's exempt purposes

depends in each case upon the facts and circumstances involved.

In Louisiana Credit Union League, 693 F.2d 525 (5th Cir. 1982), a business league described in section 501(c)(6) of the Code engaged in several activities including the endorsement of insurance to its members. The court analyzed whether these activities were substantially related to the business league's exempt purpose under section 501(c)(6) of advancing the credit union movement, in order to determine whether income generated from those activities resulted in unrelated business income to the business league. In its analysis, the court stated that the "'substantial relationship' determination is necessarily a fact-based inquiry." Id. at 535. The court also noted that the regulations under section 513 require a case-by-case identification of the exempt purpose, an analysis of how the activity contributes to that purpose and an examination of the scale on which the activity is conducted. The League promoted the purchase of insurance policies from a particular carrier, providing the carrier with convenient services in the marketing and administration of its programs. The court stated that the League's endorsement of group insurance plans was principally motivated by a desire to raise revenue. The court also discussed at length the distinction between group and individual benefit. The court said the distinction between inherently group benefits and individual benefits is analogous to the aggregate/entity concept familiar in partnership taxation.

> Just as a member of a partnership may enjoy benefits in his separate capacities as partner and non-partner, so may a member of the ..[League may]...enjoy benefits both as a League member and as an individual credit union. Only those activities that benefit the credit unions in their capacities as League members can be considered substantially related to the League's exempt function. This group benefit standard also accords with the requirement that a business league seek to improve the conditions of an entire line of business rather than perform discrete services for individuals. See Treas. Reg. Section 1.501(c)(6)-1. When the activities of a business league are directed toward the achievement of the common business interest of its members, the benefits that accrue to its members are inherently group benefits.

Id. at 536. The court continued its analysis by stating that insurance endorsement and administration is not the sort of unique activity that satisfies the substantial relationship test, nor are its benefits group-related. Id. at 536. Rather than merely advising members of the availability and desirability of insurance coverage to credit unions generally, the league promoted the purchase of polices from a particular carrier. The court affirmed the district court's rationale that the league's insurance activities did little more than generate revenue. Because the league's endorsement was basically a fundraising activity, it was by definition unrelated business activity under section 513(a). Id. at 537. Therefore, the court

concluded that the League's insurance activities were not substantially related to its tax-exempt purpose of advancing the credit union movement. Rather, the connection between the furtherance of the credit union movement and the selling of insurance was at best tangential.

In Professional Insurance Agents of Michigan v. Comm'r., 78 T.C. 246 (1982), aff'd 726 F.2d 1097 (6th Cir. 1984), the court held that promotional and administrative fees and an experience rating reserve refund received by a business league described in section 501(c)(6) of the Code for promoting group insurance programs for its members constituted unrelated business taxable income under section 512(a)(1). In holding that the business league's activities were not substantially related, the court considered whether the league's insurance activities contributed importantly to the league's exempt purpose of advancing the common business interests of independent insurance agents. The court stated the burden is on the taxpayer to show that the challenged activities contribute directly and importantly to the improvement of conditions in a particular line of business. The court noted that the petitioner's insurance activities did little more than generate revenue for the association and provided members with a convenient and economical service in the operation of their agencies. As such, they stood in sharp contrast to petitioner's educational and legislative activities, which served the broader purpose of improving the general business environment in which insurance agents operated. Thus, the court found petitioner's activity of promoting insurance was not substantially related to its exempt purpose.

In La Caisse Populaire Ste. Marie (St. Mary's Bank) v. U.S., 563 F.2d 505 (1st Cir. 1977), the Government unsuccessfully challenged the exempt status under section 501(c)(14)(A) of the Code of an organization chartered as a credit union by the State of New Hampshire. The Government maintained that the organization was not exempt because it offered a wide variety of services typically offered by nonexempt full service banks, and was therefore not organized or operated as a credit union. Among these services were checking accounts, mortgage loans, banking by mail, safe deposit boxes and a night depository. This case focused solely on the taxpayer's exemption under section 501(c)(14) and did not address the provisions of sections 511 through 513.

In Alabama Central Credit Union v. U.S., 646 F. Supp. 1199 (N.D. Ala. 1986), a credit union described in section 501(c) (14) of the Code offered cancer and group life insurance to its individual members. The issue was whether commissions the credit union received from servicing these particular types of insurance policies constituted unrelated business income under section 512. The court did not reach the issue for jurisdictional reasons; however, it stated in a footnote that the petitioner would have lost on the merits of this issue because the policies benefited the insured without any reference to the member's loans or accounts with the credit union. That court stated in dicta that cancer and group

life insurance offered by a credit union to its members would result in unrelated business table income for the following reasons:

1. Petitioner earned commissions for servicing cancer and group life insurance policies;
2. These policies were for the express benefit of the insured without any reference to the member's loans or accounts with the credit union;
3. Petitioner derived no benefit from the policies other than commission on the sale of said policies earned from the insurance companies which issued the policies;
4. The sale of the cancer and group life insurance policies referred to had no substantial, causal relationship to petitioner's exempt purposes; and
5. The sale of the policies bore no relationship to petitioner's function as a credit union.

Id. at 1208, n. 14.

Rev. Rul. 69-282, 1969-1 C.B. 155, provides that an organization must be formed and operated under the state law governing the formation of credit unions to qualify for exemption under section 501(c)(14) of the Code as a state-chartered credit union.

Rev. Rul. 72-37, 1972-1 C.B. 152, provides that to qualify as a credit union exempt from income tax under section 501(c) (14) (A) of the Code an organization must, in addition to being formed and operated under a state credit union law, operate without profit and for the mutual benefit of its members. The revenue ruling clarified Rev. Rul. 69-282, stating that a state charter is a threshold requirement for exemption but not the sole requirement.

Rev. Rul. 60-228, 1960-1 C.B. 200, interprets the substantially related requirement of section 513. An organization exempt from federal income tax as an agricultural organization described in section 501(c)(5) of the Code promoted wider insurance coverage among its members and other local farmers, including life, casualty, and fire insurance. The insurance programs are provided by several insurance companies, but the organization's administrative and secretarial staff is assigned to the work. The organization receives an overall fee from the insurance company for office and other services rendered them in connection with the insurance programs. The revenue ruling provides that a trade or business is substantially related to an organization's exempt activities if the principal purpose of the trade or business furthers these exempt purposes. However, in this case, such activities are not usually associated with the functions of an agricultural organization and normally would not be carried on by such an organization in furtherance of its exempt purposes. Therefore, these activities are not substantially related to the organization's exempt purposes.

Thus, the income resulting from these activities is subject to tax under section 511.

Analysis

In determining whether an income-producing activity is an unrelated trade or business, it is necessary to show that (1) there is a trade or business, (2) the trade or business is regularly carried on, and (3) the conduct of the trade or business is not substantially related to the organization's exempt purpose or function. See section 1.513-1 (a) of the regulations.

T has agreed that the activities at issue are trades or businesses that are regularly carried on. Therefore, the sole issue is whether each activity is substantially related to the organization's achievement of its exempt purposes.

Gross income is derived from an unrelated trade or business if the conduct of the trade or business is not substantially related (other than through production of funds) to the purposes for which exemption is granted. Section 1.513-1(d)(1) of the regulations. Determination of the substantial relationship issue requires an examination of the relationship between the business activities which generate the particular income in question, and the accomplishment of the organization's exempt purposes. Id. The regulations further state that 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. Section 1.513-1(d)(2) of the regulations. See also Prof'l Ins. Agents of Michigan, supra, (insurance activity was not substantially related because activity did little more than generate revenue and provide members with a service and did not further taxpayer's exempt purpose of improving business conditions); and Louisiana Credit Union League, supra, (League's endorsement of group insurance plans was principally motivated by a desire to raise revenue, and at best was only tangentially related to the furtherance of the League's exempt purpose of improving business conditions of one or more lines of business. The court found the requisite substantial relationship lacking.)

For T's activities to escape taxation as unrelated business income, the activities must contribute directly and importantly to the accomplishment of one or more of T's exempt purposes—promotion of thrift and providing low cost credit for its members through mutual and nonprofit operation. Section 1.513-1(d)(2) of the regulations. See also Prof'l Ins. Agents of Michigan, supra. We address each of the activities below.

Credit life and credit disability

T argues that the sale of credit disability insurance is directly related to the credit union's specific exempt purposes of fostering thrift among the members (including both the extension of credit to members on reasonable terms, and encouraging savings among the members), and providing services to members on a mutual basis. T further maintains that credit insurance, which is an integral part of a member loan transaction, is a mechanism for assuring the prompt repayment of debts in situations where the financial resources of the borrower, and the borrower's family, become strained as a result of disability.

The facts do not show how sales of credit life and credit disability insurance contribute directly and importantly to accomplishing T's exempt purposes. Credit life and credit disability insurance is not required for the approval of a loan. In fact, credit life and credit disability insurance is not available to members on certain types of loans, such as mortgage and other real estate loans. The member decides whether to purchase credit life and credit disability insurance based on his or her own assessment of whether the insurance will provide a benefit to that individual member. The individual member benefits in that the member need not worry about paying a loan to T in the event of death or disability. While there is also a benefit to the credit union as the beneficiary, the facts do not show how the sale of credit life and credit disability insurance otherwise contributes importantly and directly to accomplishing T's exempt purposes, other than through the production of income. Availability of credit life and credit disability insurance does not encourage savings or assist T in offering low cost credit.

T does not take into consideration the need for this insurance by members. T performs no studies to determine which members may need credit life and credit disability insurance, and there is no required corresponding counseling to members who may have more need than others. Although T's staff may recommend insurance based on the level of personal and family resources, these recommendations are not mandatory in specific cases and coverage is not required in these cases.

Additionally, T's receives commissions based on the amount of premiums paid for credit life and credit disability. Because the insurance is voluntary and has no bearing on the approval of a loan, the individual benefit—to the selling employee—is the primary benefit of offering the insurance.

Applying the factors of Alabama Central Credit Union, supra, T (1) earns commissions for providing credit life and credit disability insurance; (2) sells policies for the express benefit of the insured albeit with reference to a member's loan with the credit union; (3) derives some benefit from the credit life and credit disability insurance but the primary benefit is production of income, through the commission on the sale of the insurance earned; (4) the insurance referred to

has no substantial, causal relationship to T's exempt purposes; and (5) the insurance bears no relationship to T's function as a credit union.

Looking at the facts with respect to credit life and credit disability insurance, the sale of credit insurance is not substantially related to T's exempt purposes. The available information indicates that the sale of insurance is primarily: 1) for the purpose of generating income to T and some of its employees; and 2) for the benefit of the insured rather than for the benefit of T's membership. Based on all of the facts and circumstances, T's activities with respect to the sale of credit life and credit disability insurance do not contribute importantly to accomplishing T's exempt purposes. Therefore, the sale of credit life and credit disability insurance is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

Conclusion

For reasons set forth above, we conclude that the income received by a section 501(c)(14) credit union from the sale of credit life and credit disability insurance are not substantially related to the furtherance of T's exempt purposes and therefore are subject to UBIT.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

- END -