

INTERNAL REVENUE SERVICE
TE/GE TECHNICAL ADVICE MEMORANDUM

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September 21, 2005

Area Manager –

Taxpayer's Name:
Taxpayer's Address

Taxpayer's Identification Number:

Years Involved:

Conference Held:

Legend

T =
U =
V =
W =
X =

Issues

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

- A. Sale of accidental death and dismemberment (AD&D) insurance
- B. Sale of MEMBERS financial management services (formerly "Plan America")
- C. Sale of car warranties
- D. Sale of guaranteed auto protection (GAP) insurance
- E. Sale of credit life and credit disability insurance

- F. Sale of group life, health and cancer insurance and stand alone cancer insurance
- G. Sale of checks

Facts

Originally chartered in 1952, 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. Membership in T is limited to employees and family members of U.

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 provides group life, health and cancer insurance and stand alone cancer insurance, MEMBERS financial services, and car warranties available to members. T also makes available to its members AD&D insurance, GAP, CPI, and credit life and credit disability insurance in connection with several loan programs. The different types of insurance are described in more detail below. T also sells checks to its members.

All of these 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 years 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. Based on the number of loans, in 1999, 58.6% were collateralized and in 2000, 60.1% were collateralized.

The default rate on these loans as a percentage of total loans was .25% and .30% for years 1999 and 2000, respectively.

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

A. Sale of AD&D insurance

T offers AD&D insurance to its members. T states that providing this insurance is an activity that is beyond the scope of services directly associated with members' monetary deposits and loans made to members. Rather, the provision of AD&D insurance is a financial security activity that is offered to members. Under the terms of the AD&D policy, if the member has an accident that triggers a claim meeting the terms of the policy, then the member or the member's beneficiary receive specified insurance payments under the policy. In the case of accidental death, the member's beneficiary would receive payments; in the case of dismemberment, the member would receive payments.

T markets and sells AD&D insurance to its members under a policy issued by V. T has offered the program since 1994. T makes its members aware of the purpose and availability of AD&D insurance, answers members' questions about the product, refers the member to V for additional information if it is needed, and obtains and submits applications for coverage, premium payment and claims. T receives an administrative allowance for AD&D insurance based on services provided by T. The maximum reimbursement is 30% of gross premiums collected.

T has been unable to provide any information concerning the number of policies sold, the number of claims, nor percentage of member-borrowers that opted for such AD&D coverage during 1999 and 2000. T has represented that it

does not maintain records on this data and this information is not provided by the insurance company.

B. Sale of MEMBERS Financial Services Program (MFS Program)

The MFS Program is a financial services program that provides services that T does not offer. The MFS Program is V's direct response marketing program. The MFS Program authorizes V to offer insurance products to its members through a local representative. Product offers include mutual funds, variable annuities, fixed annuities, variable universal life, long term care insurance, and term and whole life insurance. V has a representative located at T and T supplies office space, furniture, equipment, phone lines, and marketing support. Pursuant to the agreement T made with V, V pays a percentage of the new business expense allowance dollars on all products offered by the MFS Program. The percentage varies based on the calendar year-to-date accumulated expense allowance. For new business expense allowance, T is paid 20% on the first \$100,000, 30% on the next \$25,000, 40% on the next \$125,000 and 50% on excess over \$250,000. T is paid 50% of the renewal expense allowance dollars. The MFS Program has been in existence since 1994.

C. Sale of car warranties

T entered into an agreement with W. The agreement provides that T would allow W to make its car warranty program available to T's members. Along with creating and disseminating marketing materials for W, T provides W with office space on T's premises to make the marketing materials and applications available to T's membership. During the new and used car loan process, T's employees offer W car warranties to members. T's employees explain to the member the benefits of purchasing a car warranty. They explain the terms of the warranty. They provide the member with brochures, which assist in selling the warranty. They compute the loan payment with and without warranty coverage. Finally, they receive and forward warranty applications to W and assist members in obtaining warranty refunds.

Under the agreement, W pays T for each warranty sold. In 1999, T sold auto warranties and for 2000 sold warranties. This equates to approximately 11% of automobile loans during 1999 and 3.66% of automobile loans during 2000. No loans were denied based on a member's failure to purchase a car warranty.

D. Sale of GAP insurance

T makes GAP insurance available to members who take out auto loans from the credit union. GAP insurance covers any shortfall between the borrower's regular auto insurance coverage and the balance of the loan on their automobile, in the event of destruction of the vehicle serving as collateral for the loan. The premium cost of the insurance coverage for the vehicle in question is charged to the member as part of the loan balance.

A loan officer informs each borrower of the availability of the GAP insurance coverage when the members obtain their loans and credit union personnel provide assistance with member claims. Obtaining the GAP insurance coverage is not a condition of the member's receiving the loan. T receives payments from the insurance company with respect to each borrower who elects GAP insurance coverage, based on the amount of premiums paid by the borrower.

T's reimbursement on GAP insurance policies is _____ per policy. GAP insurance has been offered since 1999. There were 36 GAP insurance policies sold in 1999 and 254 sold in 2000. T was not able to provide information regarding number of claims made on these policies during the years at issue. No member was ever denied a loan for failing to obtain GAP insurance.

E. 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 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 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 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 a \$50,000 policy limit. The maximum loan duration covered is 120 months and only credit union members are eligible. T does not offer 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 26 to 40 percent of the premiums written for credit disability insurance. This percentage is based on an agreement between T and the insurance company at the time the insurance was purchased. T pays bonuses to employees based on an amount per policy sold.

T does not maintain records regarding the percentage of members that opted for credit insurance during a given time period. However, at the end of 1999 there were credit disability policies and credit policies. The total number of loans during this period was At the end of 2000 there were credit disability policies and credit life policies. The total number of loans during this period was

F. Sale of group life, health and cancer insurance and stand alone cancer insurance

T markets and sells life, health and cancer insurance to its membership. T collects and remits the premiums to an insurance company.

Life and health insurance commissions are 10% of new premiums and 2% of renewals. For cancer insurance, the commission is \$7 per policy. The

commission for the stand alone cancer insurance which is offered by a different insurance company is 10% of the gross premiums collected.

The group life, health and cancer insurance has been offered since the 1950's and the stand alone cancer insurance has been offered since 1995.

T states that records are not available for the number of group life, health and cancer insurance policies and stand alone cancer insurance policies actually sold during the years at issue. These products are offered to the entire membership and have no direct relationship with the lending area.

G. Sale of checks

T has an agreement with X whereby T agrees to market and/or sell X's checks to its members. Pursuant to the contract, T agrees to use its best efforts to place orders for all of its members' requirements for checks and check-related products. X provides the base price of member's checks and T debits members' accounts for the cost of the checks. T receives a commission of approximately \$2.90 per order.

T provides its membership with brochures and order forms and answers questions regarding X's products.

T informs members that they can order checks directly from other vendors. If a member inquires about purchasing checks from another company, T states that it is an option available to the member. A member can purchase checks directly from other vendors by mail, phone, or over the Internet.

The commissions received by T for selling checks constituted less than one percent of T's total gross income. Check sales have been offered since 1976.

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 Massachusetts. 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 Massachusetts 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 is 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 policies 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 taxable 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.

AD&D insurance

T argues that making AD&D insurance available to members is substantially related to the credit union's exempt purpose of promoting thrift by providing basic financial protection to members on a mutual basis. T also argues that AD&D insurance facilitates prompt repayment of loans on a mutual basis by protecting the individual member's financial security.

The facts do not show how T's sales of AD&D insurance contribute directly and importantly to T's exempt purposes. T has not demonstrated that sales of AD&D insurance encourage savings by members who purchase it. T has also not provided information showing that the sale of AD&D insurance aids a member in obtaining credit or reduces the cost of providing credit to members. The facts do not demonstrate that the sale of AD&D insurance to individual members advances T's mutual operation. AD&D insurance provides a financial protection to an individual. The individual's purchase of the AD&D insurance does not provide a benefit to the members as a whole. The legislative history of section 501(c)(14)(A) of the Code indicates that mutuality is tied to the same members being the borrowers and lenders in loan transactions rather than the general principles that T espouses. S. Rep. No. 781 (Sept. 18, 1951).

T has not stated how the sale of AD&D insurance to an individual provides a mutual benefit to T members. The facts also do not show how sale of AD&D insurance benefits the members of the credit union as a whole. A member may purchase AD&D insurance without obtaining credit or a loan from T. If a member of T receives accidental dismemberment insurance payments, the member may use the insurance payments as he or she wishes rather than saving them or paying off an obligation to T. In the case of accidental death, the member's beneficiary may or may not be a member of T and also may use the payments

as he or she desires.

In Alabama Central Credit Union, supra, the court stated in dicta several factors cited above relevant to the “substantially related” inquiry. In this case, T (1) earns commissions for servicing AD&D insurance policies; (2) sells policies for the express benefit of the insured without any reference to the member’s loans or accounts with the credit union; (3) derives no benefit from the policies other than commission on the sale of the policies earned from the insurance companies which issued the policies; (4) the sale of the insurance policies referred to has no substantial, causal relationship to T’s exempt purposes; and (5) the sale of the policies bears no relationship to T’s function as a credit union.

Based on all of the facts and circumstances, T’s activities with respect to the sale of AD&D insurance do not contribute importantly to accomplishing T’s exempt purposes. The AD&D insurance sold benefits an individual and T receives no benefit other than the production of income. Therefore, the sale of AD&D insurance is not substantially related to T’s exempt purposes and amounts received therefrom are subject to unrelated business income tax (UBIT).

MFS Program

T argues that because Y’s direct response marketing program, the MFS Program, furthers the mutual operations required of credit unions, the income resulting therefrom is not subject to UBIT. T argues that the provision of MFS Program products contributes importantly to the credit union’s exempt purpose of promoting thrift and providing basic financial protection to members on a mutual basis. T also argues the products enhance the core repayment principal of the credit union movement.

The facts do not show how sales pursuant to the MFS Program contribute directly and importantly to T’s exempt purpose. T does not state how the sale of products pursuant to the MFS Program provides a mutual benefit to T’s members. T has not shown that sales of products pursuant to the MFS Program encourage savings by members who purchase it. The MFS Program does not provide any incentive or support for saving nor does it aid a member in seeking and obtaining a loan. There are no facts showing that the sale of products pursuant to the MFS Program has reduced the cost of providing credit to all members or benefited the membership as a whole in any way. Again, a member’s purchase of a product pursuant to the MFS Program provides financial protection to an individual that does not benefit members as a whole, other than through the production of income.

Elements of the agreement by T and Y are also indicative of the motivating goals of T. For instance, Y obtained a covenant not to compete clause, ensuring that no other company would offer the same type of products to T’s members. If T was truly concerned with enhancing the core repayment principal of the credit

union, it would offer insurance from all companies to its members so that its members would have the largest selection of benefits and costs.

Applying the factors of Alabama Central Credit Union, supra, T (1) earns commissions for offering the MFS Program; (2) sells policies for the express benefit of the insured without any reference to the member's loans or accounts with the credit union; (3) derives no benefit from the policies other than a commission on the sale of the policies earned from the insurance companies that issued the policies; (4) the sale of the insurance policies referred to has no substantial, causal relationship to T's exempt purposes; and (5) the sale of the policies bears no relationship to T's function as a credit union.

T did not provide information regarding number of products sold pursuant to the MFS Program for either 1999 or 2000.

Based on all of the facts and circumstances, T's activities with respect to the sale of products pursuant to the MFS Program do not contribute importantly to accomplishing T's exempt purposes. The facts do not show how the sale of such products contributes to T's exempt purposes of promoting thrift and providing low cost credit. The sale of products pursuant to the MFS Program does little more than produce income for T. Therefore, the sale of products pursuant to the MFS Program is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

Car warranties

T argues that making car warranties available to members is substantially related to what it believes is the credit union's tax-exempt purpose of providing basic financial protection to members on a mutual basis. In addition, T contends that in the case of warranties for automobiles serving as collateral for a credit union loan, the warranty protection contributes importantly to the underlying loan transaction and facilitates repayment.

The facts do not show how the sales of car warranties contribute directly and importantly to T's exempt purposes. T has not shown that car warranties encourage savings by members who have availed themselves of those programs. There are no facts showing that the purchase of a car warranty has reduced the cost of providing credit to all members or benefited the membership as a whole in any way. Again, the car warranties provide a financial benefit or financial protection to an individual that does not benefit the members as a whole other than through the production of income. The car warranties do not provide any incentive or support for saving nor does it aid a member in seeking and obtaining a loan.

Regarding prompt repayment of loans, a car warranty is not tied to the individual's loan. It can be purchased with or without the extension of credit by T.

The facts provided by T show that the purchase of a car warranty from T in connection with a loan increases the amount of the loan payment for the individual purchaser. Even if a car warranty is purchased in connection with a loan from T, the warranty merely pays for certain car repairs for an individual's car. It does nothing to further the credit union's exempt purpose of promoting thrift and providing access to credit.

Applying the factors of Alabama Central Credit Union, supra, T (1) earns fees for selling car warranties; (2) the car warranties are for the express benefit of the individual car buyer or insurance without any reference to the member's loans or accounts with the credit union; (3) derives no benefit from the car warranties earned from the company that provided the car warranties; (4) the car warranties referred to have no substantial, causal relationship to petitioner's exempt purposes; and (5) the car warranties bear no relationship to T's function as a credit union.

Based on all of the facts and circumstances, T's activities with respect to the car warranties do not contribute importantly to T's exempt purposes. Therefore, the car warranties are not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

GAP insurance

T argues that because GAP insurance furthers the mutual operations required of exempt credit unions, the income resulting therefrom is not subject to tax under section 511 of the Code. T further states the provision of GAP insurance contributes importantly to the credit union's exempt purpose of extending credit to members, fostering the savings of members, and otherwise providing financial services to members in a mutual fashion. T argues that GAP insurance becomes an integral part of the loan transaction and eases the financial burden on the credit union's members when the property covered by a loan requires repair or replacement. T notes that this insurance protects the credit union's savers as a whole, by lessening the likelihood that a loan secured by that property will go into default and have to be made good from the members' accumulated savings.

The facts do not show how sales of GAP insurance contribute directly and importantly to accomplishing T's exempt purposes. The facts do not show that availability of the GAP insurance encourages savings or increases the availability of low cost credit. The purchase of GAP insurance is not required for approval of a car loan. T already requires that a borrower/member have basic insurance protection on a vehicle that is collateral for a car loan. While GAP insurance covers any shortfall between the borrower's regular auto insurance coverage and the balance of the car loan in the event the vehicle is destroyed, the member decides whether to purchase GAP insurance based on his or her own

assessment of whether the insurance will provide a benefit to that individual member. T has not presented facts that show how its members benefit as a whole from the GAP insurance sales, other than through the production of income.

Applying the factors of Alabama Central Credit Union, *supra*, T (1) earns commissions for providing GAP insurance; (2) sells insurance 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 GAP insurance but the primary benefit is the commission on the sale of the insurance earned from the company that provided the insurance; (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.

Based on all of the facts and circumstances, T's activities with respect to the sale of GAP insurance do not contribute importantly to T's exempt purposes. Therefore, the sale of GAP insurance is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

Credit life and credit disability insurance

T argues that the sale of credit life and 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 are not required for the approval of a loan. In fact, credit life and credit disability insurance are 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/or 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 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 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 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 arguments do not address the fact that bonuses are paid to employees based on the number of policies sold, providing a profit-motive incentive to T's employees rather than a membership benefit as a whole. In addition, T's commissions are high, ranging from 26 to 40 percent of premiums paid.

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, both through the commission on the sale of the insurance earned and the bonuses paid to T employees; (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.

Group life, health and cancer insurance and stand alone cancer insurance

T argues that the sale of group life, health and cancer insurance and stand alone cancer insurance to members is substantially related to its exempt purpose of promoting thrift because it provides basic financial protection to members on a mutual basis. T further argues that making cancer insurance available to protect T's members against the potential financial and personal ravages associated with a life-threatening disease "contributes importantly" to the promotion of thrift and facilitation of prompt repayment of loans on a mutual basis by protecting members' financial security.

The facts do not show how sales of group life, health and cancer insurance and stand alone cancer insurance contribute directly and importantly to T's exempt purpose. T does not state how the sale of group life, health and cancer insurance and stand alone cancer insurance provides a mutual benefit to T's members. T has not shown that sales of group life, health and cancer insurance and stand alone cancer insurance encourage savings by members who purchase it. The insurance does not provide any incentive or support for saving nor does it aid a member in seeking and obtaining a loan. There are no facts showing that sale of such insurance has reduced the cost of providing credit to all members or benefited the membership as a whole in any way. Again, a member's purchase of group life, health and cancer insurance and stand alone cancer insurance provides financial protection to an individual that does not benefit members as a whole, other than through the production of income.

Regarding prompt repayment of loans, the facts do not show how group life, health and cancer insurance and stand alone cancer insurance contribute to the individual member's repayment of loans. A member who has group life, health and cancer insurance and stand alone cancer insurance may not even have a loan through T. If a member of T receives insurance payments, the member may spend the insurance payments as he or she wishes rather than saving them or paying off an obligation to T. In the case of a beneficiary, the beneficiary may or may not be a member of T and is also free to spend the payments as he or she desires.

Applying the factors of Alabama Central Credit Union, supra, T (1) earns commissions for servicing the group life, health and cancer insurance and stand alone cancer insurance policies; (2) sells policies for the express benefit of the insured without any reference to the member's loans or accounts with the credit union; (3) derives no benefit from the policies other than commission on the sale of the policies earned from the insurance companies that issued the policies; (4) the sale of the insurance policies referred to has no substantial, causal relationship to T's exempt purposes; and (5) the sale of the policies bears no relationship to T's function as a credit union.

Based on all of the facts and circumstances, T's activities with respect to the sale of group life, health and cancer insurance and stand alone cancer insurance do not contribute importantly to accomplishing T's exempt purposes. The facts do not show how the sale of group life, health and cancer insurance and stand alone cancer insurance contributes to T's exempt purposes of promoting thrift and providing low cost credit. The sale of group life, health and cancer insurance and stand alone cancer insurance does little more than produce income for T. Therefore, the sale of group life, health and cancer insurance and stand alone cancer insurance is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

Check sales

Because the sale of checks furthers T's exempt purposes, the income resulting therefrom is not subject to UBIT. Checks allow members access to their funds held on deposit. Accepting member funds for deposit, including allowing the members access to those funds is obviously a critical and central exempt function of a credit union. Therefore, the sale of checks to T member-borrowers is substantially related to T's exempt purposes.

Conclusion

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

- A. Sale of AD&D insurance
- B. Sale of MEMBERS financial management services
- C. Sale of car warranties
- D. Sale of GAP insurance
- E. Sale of credit life and credit disability insurance
- F. Sale of group life, health and cancer insurance and stand alone cancer insurance

We also conclude the sale of checks by T to its members is substantially related to the furtherance of T's exempt purposes and therefore is not 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 -