

Cite as Det. No. 99-195, 19 WTD 283 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 99-195
)	
...)	Registration No. ...
)	FY.../Audit No. ...
)	

- [1] RCW 82.04.4282 & ETA 572.04.169: B&O TAX – NONPROFIT ORGANIZATIONS – AMOUNTS RECEIVED TO ADMINISTER QUALIFIED CHARITABLE PURPOSES. B&O tax does not apply to amounts received from a grantor by a qualifying nonprofit organization for use in offsetting the administrative expenses of administering the grants and carrying out the nonprofit’s charitable purpose.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Taxpayer, a private university, is an I.R.C. §501(c)(3) nonprofit educational institution for federal tax purposes and a nonprofit corporation for state tax purposes. It petitions for correction of a Department of Revenue (“Department”) auditor’s conclusion that business & occupation (“B&O”) tax applies to an offset amount the university receives for costs of administering federal student loans and grants for the benefit of qualified students.¹

FACTS:

Johnson, A.L.J. – The taxpayer (“University”) is an independent private university located in Washington state. Its records were examined for calendar years 1993-1996. University protests assessment of B&O tax on certain revenues believed by the auditor to have been payments for services rendered.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

As a part of University's mission of providing educational opportunities, it participates in a joint effort with the federal government to provide financial aid to its students. University's controller explained that United States Department of Education's student financial assistance programs provide post-secondary students with need-based grants, loans, and work-study opportunities. Three of these programs are called "campus-based", because they are managed at the campus level. These programs include the Federal Supplemental Education Opportunity Grant ("FSEOG"), Federal Perkins Loan, and Federal Work-Study ("FWS"). Some schools that participate in other federal student financial assistance programs choose not to participate in the campus-based programs because of the extensive administrative responsibilities imposed on the school. The taxpayer explains:

Many of [University's] students pay their tuition with the assistance of the Department of Education's student financial assistance programs. [By footnote, the University explains the programs include the Federal Pell Grant Program, Federal Family Education Loan Program, Federal Direct Student Loan Program, FSEOG Program, and FWS Program, which the petition refers to as the "Programs".] Some of these loan and grant programs are funded entirely by the federal government; others, such as the Federal Perkins Loan Program ("Perkins"), require [University] to contribute a portion of the loan or grant trust corpus that is ultimately available for distribution to its students. Under federal law, [University] is obligated to contribute one-quarter of the combined federal and university contributions to the revolving Perkins loan fund. 20 U.S.C. § 1087c(a)(2)(B).

[University's] participation in the Programs is governed by the United States Department of Education's Program Participation Agreement, to which [University] is a signatory. Under the terms of the Participation Agreement, [University] may elect to administer the Programs itself or hire an eligible third party servicer, as defined by specific regulatory criteria, to handle administration.

(Brackets supplied.)

University's controller explained that University, as do many schools, has decided to administer its own financial aid programs, including the federal programs. University based this decision on the critical need to ensure that the full spectrum of complex and changing federal and state regulations are carefully monitored. The governmental accounting and assessment compliance, reporting, and service components of the programs take a considerable amount of staff time. Even if University elected to use one of the few existing third-party providers available, none of these outside parties offers the full spectrum of services necessary to deliver the aid. Additionally, 34 C.F.R. § 668.25, cited in the Participation Agreement, warns schools they will be "liable for all improperly administered funds. . . including any funds administered by a third-party servicer. . . ." (Emphasis supplied.) Improper behavior by a third party could operate to cost University the opportunity to deliver aid to its students and is not considered to be worth the risk.

Pursuant to the Participation Agreement with the United States Department of Education, University receives what appeared to the auditor to be a payment for its administrative services, in addition to the funds transferred from the federal government to, and supplemented by, University. An examination of the arrangement led the Audit Division to conclude University was engaged in a taxable activity, that of providing administrative services to the financial aid effort, with the object of gain, benefit, or advantage to itself or another. University's controller commented during the hearing that Audit had worked closely with University to clearly understand the transaction and attempt to work out a compromise but had concluded, as stated in the audit report, that the Department "finds no exemptions or deductions for reimbursements of costs associated with administering" the federal loan fund.

The controller explained that the transaction essentially works as follows:

1. University annually receives from the federal government an award letter, called the Official Notice of Funding. This letter details how much money the government has allocated to University's federal campus-based programs for the grant period.
2. Following strict federal and University guidelines, University awards grants, loans, and work-study amounts to qualified students.
3. University reports the awards to the government via on-line reporting systems.
4. University draws down the available funds, usually at or near the beginning of school semesters, in accordance with federal rules. The draw-downs are limited to the amounts specified for the grant period in the award letter.
5. A school participating in the federal campus-based programs is entitled to an allowance to help offset administrative costs. The federal government requires that the administrative cost allowance be taken out of the annual award allocation under these grants for FSEOG and FWS programs and from available cash in the revolving federal Perkins loan fund. This allowance is not received in the form of a separate amount sent to the school. A school may draw its allowance from any combination of campus-based programs, or from only one program, provided there are sufficient funds in that program. The administrative allowance only partially offsets University's actual costs of administering the Programs.
6. The government strictly dictates how University must apply the offset amount. It must be applied to actual administrative expenses incurred, or it must be applied toward community outreach programs, which increase access to the grant or loan programs and, thus, further the educational mission of University. University's controller explains the amounts are drawn down from DOE, as are other qualified expenditures under the grant, such as the students' funds. Grant income is recorded upon receipt of funds from DOE, and a journal entry is recorded to charge one of the campus-based programs.

University believes the Department's view that the offset amount is a payment for services fails to reflect the reality of the transaction. It is also frustrated that this issue has never been raised in

its prior audits or in audits of other similar schools with which it is familiar through its business association.

University argues that the complex federal statutory scheme creates a trust relationship between participating schools and the federal government and that the trust's sole purpose is to accomplish the I.R.C. § 501(c)(3) mission of operating "...for educational purposes...". As a prerequisite for participation in the Programs, University must meet extensive reporting and compliance burdens. It is deemed by federal law to act "as a fiduciary responsible for administering Federal funds" from the trust for the benefit of the students served by University. (34 C.F.R. § 668.14(b)(2).)

University argues it is engaged in a joint effort with the federal government to further the I.R.C. § 501(c)(3) educational purposes of its mission and for which it has received federal tax-exempt status. As a part of its mission of delivering educational services, University must make education available to deserving students of varying financial means. University and the government have chosen to further this goal by making several types of financial aid accessible to qualifying candidates. University achieves the goal of delivering financial aid, in part, by providing administrative services in accordance with strict, federally mandated requirements for participating in the Programs. As stated previously, the offset amount received from the federal government represents less than half the actual administrative costs involved in providing the financial aid. University's performance of the administrative services is undertaken to ensure that federal requirements are followed and that no steps are missed in delivering financial aid to students.

University argues the federal government and University contribute differently toward achieving the joint goal. Both contribute money. Both also contribute administrative services, for which the government allows University a partial offset; this offset nets out to effectively reduce the total economic contribution University is obligated to make to the joint effort. The funds are delivered from the federal government to University, over the course of the grant period as qualified expenditures are incurred, up to the limits of the government-allocated funding. The vast majority of the funding is passed on to students, with a small portion retained to cover the costs of administering the programs.

ISSUE:

Does B&O tax apply to an offset amount received by a nonprofit entity, when the amount is used directly in accomplishing the accredited nonprofit university's educational mission?

DISCUSSION:

The Department has worked with nonprofit [organizations] in recent years to clarify the Department's position on grant income. A result of this effort was the issuance of Excise Tax

Advisory 572.04.169 (ETA 572)², which states it “represents a clarification and not a change in the Department’s position.” As a result, the treatment clarified in ETA 572 is available throughout University’s audit period. ETA 572 cites RCW 82.04.4282, which states, in part that a deduction from B&O tax may be taken for “amounts derived from . . . (3) contributions, (4) donations, (5) tuition fees . . . and (8) endowment funds.” The Advisory goes on to state:

Though "grants," which may be referred to as "gifts" or "awards," are not specifically included in RCW 82.04.4282, the Department will presume that a grant consisting of an award of money, goods, property or services is a bona fide "contribution," "donation," or "endowment" within the scope and spirit of the deduction intended by the legislature when: (1) the grantor receives no significant goods, services, or benefits in return for making the grant; (2) the grantee is a nonprofit or governmental entity; and (3) the grants are used to promote, advance, or fulfill charitable purposes, including the administrative expenses related to the charitable purposes, within the meaning of sections 501(c)(3) of the Internal Revenue Code and the regulations and case law administering and interpreting that section.

It is not unusual for the person making a gift, whether by contribution, donation, grant, or endowment, to require some accountability for how the gift is used as a condition of receiving the gift or future gifts. This "accountability" can take the form of conditions or restrictions on the use of the gift or grant for specific charitable purposes or can take the form of certain written reports. The requirement to expend grant funds in a certain way or to provide written reports is not sufficient to determine if a taxable service was performed. Financial reports which simply indicate by category how the funds were used are an example of an "accountability report." Reports which discuss the nature of the project performed are also considered to be "accountability reports." A report or study that provides a significant good or service for the benefit of the grantor, such as a report on the soil contamination levels of the grantor, is not an "accountability report."

Grants in which the grantor receives public acknowledgment of the grant or gift are not taxable simply by reason of acknowledgment of the gift.

(Emphasis supplied.)

We believe that ETA 572 intends to cover administrative expenses “related to the charitable purposes” of the nonprofit and that ETA 572 covers situations where a portion of qualifying funds is intended for or clearly understood to be used for costs of administering the qualifying purposes. The reality in University’s case is that the tracking of costs and “offsetting” with the allowable portion of retained grant/award funds received from the federal government are clearly more for accounting purposes than proof of nonexempt services rendered by University to the government. Even if this were not the case, the Department has recognized that nonprofits

² Formerly referred to as Excise Tax Bulletin. All current Excise Tax Bulletins were converted to Excise Tax Advisories effective July 1, 1998.

sometimes operate as “conduits” for funds. We believe this understanding operates to keep both the financial aid amounts used for qualifying charitable purposes and the amounts used to offset the necessary accompanying administrative expenses from being subject to B&O tax and is consistent with Det. No. 98-004, 17 WTD 231 (1998).

DECISION AND DISPOSITION:

Taxpayers’ petition is granted, and B&O tax assessed on offset amounts received for administrative costs will be cancelled.

Dated this 23rd day of June 1999.