Published on *The National Law Review* https://natlawreview.com

Qualified Student Loan Bonds

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A Diminished Market, But Still Functioning in More Limited Ways

The IRS issued Notice 2015-78 [link] ("2015 Student Loan Notice" or "Notice") on November 13, 2015. To some, it was unclear why the IRS would bother issuing any guidance for a narrow type of tax-exempt bond that is issued in a vastly diminished volume as a result of changes in federal higher education laws. However, the perceived need for this Notice may have originated, at least in part, in Private Letter Ruling 201447023 ("2014 PLR"), discussed in this blog last year [link] ("2014 PLR Blog").

A Very Abbreviated and Oversimplified History of Student Loan Bonds. The Higher Education Act of 1965 [link] ("Higher Ed Act") created a federal student loan program that lasted for 45 years. Prior to the passage of the Higher Ed Act, student loans were made directly by the federal government. Under the Higher Ed Act, loans to students were made by commercial lenders such as banks in the private sector and repayment of the loans would be guaranteed by and subsidized by the federal government. This program was titled the "Federal Family Education Loan Program," or FFELP. Both undergraduate and graduate students and their parents could borrow under the program. Graduate students borrowed under the Stafford Loan program. Parental loans were governed by a program called the "Plus Loan" program. Many tens of billions of dollars of FFELP loans, including Stafford Loans and Plus Loans, were made.

In addition to the FFELP program, many states created their own programs, applicable in their jurisdictions, to originate supplemental loans ("State Supplemental Loans"). State Supplemental Loan programs often applied to both undergraduates and graduate students and their parents, much like the FFELP program. They were typically described as supplemental loans because they were designed to fill gaps in the cost of financing higher education not covered by the FFELP program. Like FFELP student loans, State Supplemental Loans involved a direct loan from a commercial lender to students or parents that the State would typically guarantee and subsidize. Because of their supplemental nature, the market for State Supplemental Loans was smaller than the market for FFELP loans.

Then, in the 1970's, states and local governments began to issue tax-exempt bonds to provide capital for state and local student loan authorities to buy both the FFELP and State Supplemental Loans from the commercial lenders, thus providing liquidity through a secondary market for the loans. Many banks originated student loans and then sold their entire portfolio of student loans to the student loan authorities, which used student loan bond proceeds to acquire the portfolio. Soon, billions of dollars of student loan bonds were being issued each year. These student loan bonds were revenue bonds, supported solely by the payments in respect of the student loans.

Initially, these student loan bonds were treated as governmental bonds, and were not what the 1954 Code described as industrial development bonds (and that are now known as "private activity bonds", which are subject to many more restrictions than governmental bonds). In 1984, Congress changed the tax-exempt bond rules to make interest on what were described as "private loan bonds" taxable. But "qualified student loan bonds," under then-applicable Section 103(o) [link] were not treated as "private loan bonds" for this purpose.

When the 1986 Tax Act put the Internal Revenue Code of 1986 in place, the concept of a qualified student loan was incorporated into Section 144(b) of the Code [link]. But now qualified student loan bonds were private activity bonds and subject to volume cap limitations. Nonetheless, the issuance of qualified student loan bonds continued at a high volume.

Then, Congress adopted the Health Care and Education Reconciliation Act of 2010 [link], which eliminated the FFELP program and reverted back to a program of direct federal government student loans. Suddenly, the size of the student loan bond market began to shrink and shrink rapidly.

Today's Reality. As discussed in our 2014 PLR Blog, while student loan bond issuance has declined, qualified student loan bonds are still being issued for certain purposes. The 2014 PLR talks about the financing of Consolidation Loans and the requirements for those bond financings. The 2014 PLR hints at some of the topics covered in the Notice, including the important topic of "nexus".

Two kinds of qualified student loan bonds are currently being issued, (i) refundings of both FFELP program and State Supplemental Loan program qualified student loan bonds, and (ii) new money issues under State Supplemental Loan programs. The IRS issued the 2015 Student Loan Notice to clarify a few matters in the market for student loan bonds, dealing primarily with State Supplemental Loans, and building on the concepts in the 2014 PLR.

The 2015 Student Loan Notice. In reading the Notice, it is important to keep in mind that there are rules about student loans and rules about qualified student loan bonds. Qualified student loan bond proceeds can only be used to acquire eligible loans. The Notice primarily deals with the requirement for a student loan or a refinancing of a student loan to be eligible under Section 144(b)(1)(B) to be financed with the proceeds of a qualified student loan bond. While the Notice is oriented to State Supplemental Loan programs, it also provides some guidance for refunding bonds that refund qualified student loan bonds originally issued to acquire FFELP loans.

The rules for “original” student loans may be different from the rules for “refinancing” student loans. An “original” student loan is the loan that the student uses to pay for education expenses. A “refinancing” student loan is the loan that the student uses to pay off the original student loan, which is usually done where the refinancing loan can be obtained at an interest rate lower than the original student loan.

It is also useful to consider that student loan bond documents may have a feature that allows the issuer to recycle the bond proceeds to buy additional student loans under certain circumstances when the principal balance of student loans in the acquired portfolio are paid down or paid off. Thus, it may be possible for both new money and refunding student loan bonds to acquire both original and refinanced loans on a continuing basis. For these reasons, the Notice covers four topics.

First, the Notice makes it clear that an “eligible” borrower of a student loan under Section 144(b)(1)(B) can be the student or the parent and that the eligible borrower for a refinancing loan is the student or the parent from the original loan.

Second, the Notice clarifies some uncertainties about the "nexus" requirement. Section 144(b)(3) states that a student loan can only be financed with student loan bond proceeds if the student beneficiary of the student loan (i) is a resident of the state that provides the volume cap for the bonds (i.e., the state in which the issuer resides) or (ii) is enrolled at a higher education institution in that state. There was never any great uncertainty about how the nexus requirement is applied when an original loan is originated from proceeds of a new money bond issue. But it was not as clear what happened if a student loan was refinanced and the student had moved out of state, or if the student loan bonds were refunding bonds.

The Notice makes clear that, for a bond issue subject to the volume cap rules in Section 146 of the Code [link], in the case of a refinancing loan, you can look at either (i) the nexus of the student at the time of the original student loan, or (ii) the nexus of the student at the time of the refinancing student loan. If the bond issue is not subject to the volume cap limitations, which will often be the case for refunding bonds (so long as the amount of the refunding bonds does not exceed the amount of the refunded bonds), the nexus requirement is applied with respect to the state from which the volume cap for the original new money student loan bond was derived.

For example, assume that a student borrower lived in Texas and went to college in Texas when the student borrowed the original student loan. Now, the student has moved to California and refinances the student loan. Under these facts, if a student loan authority in California issues new money student loan bonds and uses the bond proceeds to buy the refinancing student loan, the nexus requirement will presumably be met because the California issuer must obtain California volume cap to issue new money qualified student loan bonds. But, if a California student loan authority issues refunding bonds and does not need or obtain volume cap because of the refunding volume cap exception in Section 146, those refunding bond proceeds cannot be used to buy the refinancing student loan from the student who lived in Texas at the time the student loan was originated, even though that student now lives in California. The simple message of the Notice seems to be that a refinancing loan cannot be financed by an issuer in another state unless that issuer obtains volume cap for its bonds that finance that refinancing loan. This is consistent with the apparent purpose of the language in Section 144(b)(3) that the control factor for nexus purposes is volume cap. This nexus guidance presumably applies to both FFELP and State Supplemental Loan programs.

Third, Section 144(b)(1)(B) has a limit on the size of a State Supplemental Loan program student loan. The limit on loan size is the gap between the total cost of attendance and the other forms of student assistance available, all of which is based on references to a couple of federal statutes. Again, this was relatively determinable at the time of an original loan. The Notice makes it clear that if the loan is refinanced, the size limit will be deemed met if (i) the original loan met the size limit and (ii) the principal amount of the refunding loan does not exceed the sum of the refinanced loan's outstanding principal amount plus any accrued and unpaid stated interest. If the State Program student loan does not meet this requirement, it cannot be financed with tax-exempt student loan bonds.

Fourth, the Notice makes clear that a State Program loan can refinance (i) a loan that was itself a State Program loan or (ii) another type of original loan, such as a FFELP program loan or a student loan made by a private lender, as long as the refinancing loan qualifies under the State Program.

Conclusion. The 2015 Student Loan Notice is another in a developing trend of helpful guidance from the IRS. It adds some clarity to how student loan authorities must analyze State Supplemental Loans and refinancing loans before they can be acquired with proceeds of a tax-exempt qualified student loan bond.

This humble blogger would like to express his sincere gratitude to our retired partner and my former comrade in arms with regard to student loan financings, the legendary Jack Browning, for his invaluable insights included in this post.

National Law Review, Volume V, Number 324