



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your original memorandum dated January 13, 1999 and supplemental memorandum dated April 2, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Fund	=
State	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
\$a	=

ISSUE:

Whether the income of a private, nonprofit corporation established under state law to provide workers= compensation insurance is exempt from Federal income tax under I.R.C. ' 115(1) for the tax years 1992 through 1997.

CONCLUSION:

Based on the information provided, the income of the corporation is not exempt from tax under section 115(1) for the tax years 1992 through 1997 because the income of the corporation does not accrue to the state. We do not have sufficient information to determine whether the corporation qualifies for exemption under section 501(c)(27)(B) for years beginning after December 31, 1997. To avail itself of the provisions of section 501(c)(27), the corporation must apply for recognition of exempt status under established Internal Revenue Service procedures.

FACTS:

Fund is a private, nonprofit corporation that was authorized by an amendment to State=s constitution and created pursuant to a related State statute in Year 1. The enabling legislation provided that it is the purpose of Fund to provide a residual market for employers that have in good faith been unable to obtain workers= compensation insurance in the voluntary market; to provide a competitive market for preferred risk policies; and to insure that rates charged are adequate to provide solvency and self-funding of the corporation. Fund receives moneys from two sources: the collection of premiums and the issuance of bonds.

State statute contains a full faith and credit provision providing that State may advance funds to cover any shortfall incurred by Fund. However, both the statute and state constitution provided that any advance was to be in the form of a loan. State constitution provides that Fund is not an agency of State and the assets of Fund are not property of the State. The income of Fund is used for the payment of insurance benefits, administrative expenses and debt service. Fund=s employees are not considered employees of State.

Originally, the governor of State appointed five of the nine voting members of Fund=s board of directors. The board also consisted of 3 nonvoting members: a member of the State Senate, a member of the State House of Representatives and the Insurance Commissioner or his designee. The statute was amended to require that Fund=s initial

board of directors be appointed by the governor, by the state legislature, or by both. Your memorandum indicates that subsequent board members may be elected by policyholders.

State amended the full faith and credit provision to remove the requirement that contributions by State are subject to repayment by Fund. In addition, the revised statute provides that assets remaining on dissolution of the Fund are to be held in trust to pay the claims of policyholders and beneficiaries and any remaining assets shall be transferred to State. State's constitution was not amended to reflect the changes to the statute and still provides that advances to the Fund shall be treated as loans. Further, a provision describing the duties of Fund's board provides that the board may accept funds from State subject to the restrictions contained in the constitution.

Fund has filed Forms 1120-PC since its inception in Year 1, reporting zero tax liability based on its contention that its income is excluded from taxation under section 115 of the Code.

State's Insurance Commissioner conducted an examination of Fund's activities for Year 2, Year 3 and Year 4.

Due to the lack of certainty with respect to the Fund's status, the Insurance Commissioner concluded that a \$ reserve fund should be set aside in the event the Service rules that the Fund is not exempt from Federal income tax.

LAW AND ANALYSIS

Income earned by an entity organized separately from a state or political subdivision may be exempt under section 115. Specifically, section 115(1) provides that income is excluded from taxation if it is derived from the exercise of any essential governmental function and accrues to a state or any political subdivision.

Section 115(1) does not require that the income from the activity accrue exclusively to a state. In Rev. Rul. 77-261, 1977-2 C.B. 45, for example, a state and participating political subdivisions had an unrestricted right to receive a proportionate share of the income earned from a joint investment fund. The ruling concluded that the income from the investment fund accrued under section 115(1) even though more than one governmental entity participated in the fund.

Section 115(1) does not apply, however, if there is more than an incidental private benefit connected with the income generated by the activity. Rev. Rul. 90-74, 1990-2 C.B. 34. In the cited ruling, the Service considered the income of an organization formed, operated and funded by political subdivisions to pool their casualty risks, or other risks arising from their obligations concerning public liability, workers' compensation, or employees' health. The ruling held that such income is excluded from gross income under section 115(1) if private interests do not participate in the organization or benefit more than incidentally from the organization. *Id.* The accrual test is satisfied because the income was used to reimburse casualty losses incurred by the counties or to reduce annual fees the member counties would otherwise be required to pay. Furthermore, upon dissolution, assets of the entity are distributed to the state. *Id.*

At least one court has also looked at the extent of the state's financial obligation to an entity for purposes of determining the applicability of section 115. In Maryland Savings-Share Insurance Corp. ("MSSIC") v. United States, 308 F.Supp. 761 (D.Md.), rev'd on other grounds, 400 U.S. 4 (1970), the State of Maryland formed a corporation to insure the customer accounts of state chartered savings and loan associations. Under MSSIC's charter, the full faith and credit of the state were not pledged for MSSIC's obligations. The district court rejected MSSIC's claims of intergovernmental tax immunity and exemption under section 115, because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Thus, the imposition of an income tax on MSSIC would not burden the State of Maryland. Although the district court was reversed on other grounds, the Supreme Court agreed with the lower court's analysis of the tax exemption issues. The Supreme Court rejected MSSIC's position that "it is an instrumentality of the State and hence entitled to exemption from federal taxation under the doctrine of intergovernmental immunity and under section 115." MSSIC, 400 U.S. at 7, n. 2.

From the information provided, it does not appear that the income from the Fund accrues to State. There is no suggestion that State directly receives any portion of Fund's

income. Moreover, the extent of financial commitment to the Fund is unclear despite the changes to state law. The original statute provided that State may advance funds to cover any shortfall incurred by Fund, but such advance was to be in the form of a loan. Although the statute was subsequently amended to remove the repayment requirement and to provide that assets shall be distributed to State upon Fund's dissolution, the constitution has not been amended and reflects prior law. In addition, the board's ability to accept funds from State is apparently subject to the requirement in the constitution that advances be repaid. The constitution also provides that Fund is not an agency of State and the assets of Fund are not property of the state. Considering the apparent conflict with the state constitution, the revised statute may provide no additional financial commitment from State than prior law.

Finally, Fund provides insurance of a commercial nature. The income from Fund is used for the payment of insurance benefits, administrative expenses and debt service. The commercial insurance provided by the Fund and the resulting benefit to private employers is a private benefit that precludes the application of section 115(1).

While not raised in your request for advice, income earned by an entity is generally not subject to taxation if such entity is an integral part of a state or political subdivision of a state. See Rev. Rul 87-2, 1987-1 C.B. 18. Whether an enterprise is an integral part of a state depends upon all the facts and circumstances, including the state's degree of control over the enterprise and the extent of the state's financial commitment to the enterprise.

As with the analysis under section 115(1), the integral part test would not provide the Fund with a basis for exemption from Federal taxation. Again, State's financial commitment to the Fund is questionable, at best, given the conflict between state statute and the constitution. Further, the element of control is lacking. Fund is not a state agency and its personnel are not employees of the state. While the current statute provides that Fund's initial board members are appointed by the governor, it appears that subsequent members may be elected by policyholders. Accordingly, it is our opinion that an argument by the Fund that it is an integral part of the state would not be supported by the facts.

In addition to the above theories, the Taxpayer Relief Act of 1997 provides an additional means of exemption for certain organizations. Specifically, section 501(c)(27)(B), provides an exemption for any organization (including a mutual insurance company) if - -

- (i) such organization is created by State law and is organized and operated under State law exclusively to - -

(I) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if such insurance is not purchased by an employer, and

(II) provide related coverage which is incidental to workmen's compensation insurance.

(ii) such organization must provide workmen's compensation insurance to any employer in the State (for employees in the State or temporarily assigned out-of-State) which seeks such insurance and meets other reasonable requirements relating thereto,

(iii) (I) the State makes a financial commitment with respect to such organization either by extending the full faith and credit of the State to the initial debt of such organization or by providing the initial operating capital of such organization, and (II) in the case of periods after the date of enactment of this subparagraph, the assets of such organization revert to the State upon dissolution or State law does not permit the dissolution of such organization, and

(iv) the majority of the board of directors or oversight body of such organization are appointed by the chief executive officer or other executive branch official of the State, by the State legislature, or by both.

The cited provision is effective only for tax years beginning after December 31, 1997. Accordingly, the Fund may not avail itself of this provision for the years under consideration. Further, to benefit from the provisions of section 501(c)(27)(B), the Fund must apply for recognition of exempt status under the procedures enumerated in Rev. Proc. 99-4, 1999-1 I.R.B. 115. The ultimate question of whether the Fund qualifies for exempt status under section 501(c)(27)(B) cannot be determined until such application is submitted.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

