

## Internal Revenue Service

Department of the Treasury

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### Legend

State =  
Fund =  
Local EDC =

Entity =  
Act 1 =

Act 2 =

Act 3 =

Executive Order =  
Agreement =

Dear

This is in response to the private letter ruling request dated September 2, 1999 that was submitted by Entity's representative. The ruling request has been supplemented by correspondence dated October 22, 1999, November, 1, 1999, December 20, 1999, December 29, 1999, January 11, 2000, and January 31, 2000.

### ISSUES

Entity has requested the following rulings:

1. Is Entity exempt from the Federal Unemployment Tax Act (FUTA) under § 3306(c)(7) of the Internal Revenue Code?
2. Are contributions and gifts to or for the use of Entity charitable contributions within the meaning of § 170(c)(1) of the Code?

### CONCLUSIONS

1. Entity is a wholly owned instrumentality within the meaning of § 3306(c)(7). Therefore, the services performed by Entity's employees are excluded from employment for FUTA purposes. Accordingly, Entity is not subject to the FUTA tax under § 3301 of the Code with respect to wages paid to its employees.
2. Contributions or gifts to or for the use of Entity are charitable contributions as defined in § 170(c)(1).

### FACTS

Entity is a state-wide economic development corporation (EDC) created by Agreement between Fund and Local EDC, pursuant to Act 1, a State statute, and Executive Order of the Governor of State.

Under Act 1, a public agency of State may exercise jointly with any other public agency of State any power, privilege, or authority which the agencies share in common and which each might exercise separately. A joint exercise of power pursuant to Act 1 is made by contract in the form of an agreement. The contract may establish a separate legal or administrative entity. The contract may specify the manner of employing, engaging, compensating, transferring, or discharging necessary personnel, subject to the provisions of applicable civil service and merit systems and certain other restrictions. Although the definition of public agency under Act 1 does not specifically include EDCs or corporations created by governments, the office of the State Attorney General reviewed Agreement and recommended to the Governor that it be approved, thus implicitly approving EDCs as public agencies that may enter into agreements under Act 1.

Fund is a State agency created by the legislature of State. It operates within a department of State government. Fund has a nine-member board of directors. Two members of the board are State officials who serve ex officio, and the other seven members are appointed by the Governor. Fund's purpose is to diversify, expand, and develop State's economy so as to preserve existing jobs, to create new jobs, and to reduce the cost of business and production. Its powers include the power to make grants, loans and investments; the power to guarantee and insure loans, leases, bonds, notes, or other indebtedness, public or private; the power to borrow money and issue bonds and notes to finance part or all of the project costs of a project; and the power to engage personnel as is necessary. State statute imposes limitations on the total debt that can be owed to Fund. Fund is successor to the various preexisting economic development entities of State. State is not liable on notes or bonds of Fund, and the notes or bonds of Fund are not considered a debt of State.

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An EDC is created by a municipality of State pursuant to Act 2, a State statute. Its creation must be approved by the local governing body, which may make such amendments to the proposed articles of incorporation as it considers appropriate. The chief executive officer of a municipality, with the advice and consent of the governing body, appoints the members of the board of directors.

Act 2 states that the legislature finds it necessary to assist and retain local industrial and commercial enterprises and that therefore, the powers granted in Act 2 constitute the performance of essential public purposes and functions for State and its municipalities. Under Act 2, municipality means county, city, village, or township. Local public agency means the official body of a municipality authorized to plan and implement the development and redevelopment of the municipality. An EDC has powers similar to those of Fund, including the power to issue bonds.

Bonds issued by an EDC are exempt from all taxation except for inheritance and transfer taxes, and the interest on the bonds is exempt from all taxation in State, notwithstanding that the interest may be subject to federal income tax. The municipality is not liable on notes or bonds of the EDC, and the notes and bonds are not a debt of the municipality.

An EDC must report to the municipality once a year. The report must fully describe the activities of the EDC, including a statement of all revenues and expenditures since the previous report. Any net earnings of the EDC beyond that necessary for the retirement of indebtedness or to implement the public purposes or program of the municipality may not inure to the benefit of a person other than the municipality and, upon dissolution of the EDC, belong to the municipality. Upon dissolution of the EDC, title to all property owned by the EDC, subject to existing rights in other parties, vests in the municipality. An EDC is exempt from all state and local taxation on its earnings or property.

Act 2 provides that an EDC is considered an instrumentality of a political subdivision for purposes of Act 3, a state statute requiring state agencies, including instrumentalities, to provide a relocation assistance advisory services program for persons displaced from real property by a program of a state agency or instrumentality.

You assert that Local EDC is an integral part of the municipality in which it is created. You note that Local EDC personnel are employees of the municipality, covered by the municipality's pension plan and other employee benefits programs.

Under Executive Order (issued by the Governor of State), all State economic development programs were transferred to and reorganized into Fund. Executive Order provides for Fund to enter into an agreement with one or more local public agencies pursuant to Act 1 to provide for a public body corporate, to be called the State economic development corporation (Entity). Executive Order states Entity's purpose to include the joint exercise of shared power, privilege, or authority of Fund and the local

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public agencies to perform effective economic development programs and functions. The agreement may provide that Fund contribute any personnel, services, facilities, property, franchises, powers, responsibilities, or funds to Entity as permitted by law and as are necessary to carry out the purposes of Executive Order, with the exception of all taxable and tax exempt bond issuance authority. The agreement must provide that State civil service employees detailed to Entity will continue in the State classified service and in the State benefit system, including wages, pension, seniority, sick leave, vacation, health, welfare, and other benefits.

Agreement is an agreement between Fund and Local EDC. An EDC may become a participant under Agreement by submitting a request form to the chief executive officer of Entity. All property owned by Entity is owned by Entity as a separate legal entity and public body corporate, and no party has any ownership interest in Entity property.

Agreement terminates upon withdrawal of Fund or when there is fewer than one EDC participant. Upon termination of Agreement, all of Entity's debts, liabilities, and obligations to its creditors and all expenses incurred in connection with the termination of Entity and distribution of its assets are to be paid first and the remaining assets, if any, are to be distributed to Fund, or any statutory successor. In the event that neither Fund nor a statutory successor exists, the remaining assets are to be distributed to State. No participants may receive any assets upon termination of Agreement.

Agreement provides that the governing body of each participant EDC appoints one member of Entity's board. Governing body is not defined in Agreement. However, in Act 2, under which EDCs are created, it is defined as the body in which the legislative powers of a municipality are vested. For each member of the board appointed by the governing body of a participant, the Governor of State appoints up to two members of the board. The board authorizes and approves the annual audit, evaluates the performance of Entity pursuant to standards established by the executive committee, and may review acts of the executive committee as deemed necessary. Board meetings must comply with the open meetings act. Board members are not compensated for performing their duties, but they are reimbursed for reasonable expenses.

Entity has an executive committee of 17 members, all appointed by the Governor of State--four representatives of public agencies and 13 additional members, at least 10 from the private sector. Members serve staggered terms. The executive committee exercises the powers of Entity. The executive committee appoints the chief executive officer of Entity, who administers all programs, funds, personnel, contracts, and all other administrative functions of Entity, subject to oversight of the executive committee. Executive committee meetings are subject to the open meetings act. Members of the executive committee receive no compensation but are reimbursed for reasonable expenses.

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Entity is to prepare audited financial statements annually in accordance with generally accepted accounting principles. The statements are to be accompanied by a written opinion of an independent certified public accountant. A copy of the annual financial statement and report must be filed with the State Department of Treasury. The documents and records of Entity are subject to audit by the auditor general of State. Each fiscal year, the chief executive officer of Entity is to prepare a budget and performance standards for review by the executive committee. Entity must deposit and invest funds of Entity, not otherwise employed in carrying out the purposes of the Entity, in accordance with an investment policy established by the executive committee consistent with laws regarding investment of public funds.

Under Agreement, Fund transferred to Entity all assets and liabilities of Fund, except that Fund continues to service its notes and bonds. Further, Fund transferred to Entity all State appropriated funds and related obligations, after deduction for personnel and related operational costs of State employees. The ability of Fund to make such transfers is subject to annual appropriations by the legislature. Agreement provides for Fund to transfer to Entity all new or other revenue that Fund receives.

Fund transferred to Entity all the authority, powers, duties, functions, and responsibilities, including the functions of procurement, the day-to-day supervision of detailed personnel, and management-related functions of the programs transferred. Fund detailed 230 State classified service employees to Entity. These employees continue in the State benefit system including wages, pension, seniority, sick leave, vacation, health and welfare, longevity, and other benefits.

In addition to the 230 state employees detailed to Entity, Entity has 17 corporate employees who are not employees of State. It is with respect to these non-State employees that Entity requests its ruling as to § 3306.

### LAW AND ANALYSIS

#### Issue 1:

Section 3301 of the Code imposes an excise tax on every employer with respect to individuals in his employ. The amount of tax is equal to a percentage of total wages paid during the year with respect to employment. Section 3306(c) defines employment to include any service by an employee, with certain specified exceptions. Section 3306(c)(7) provides an exception for employment performed in the employ of a state or any political subdivision of a state or any instrumentality which is wholly owned by one or more states or political subdivisions.

Accordingly, if an organization is a wholly owned instrumentality of a state or political subdivision thereof, any wages paid to the organization's employees are not subject to the FUTA tax.

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The following six factors are considered in determining whether an organization is an instrumentality of one or more states or political subdivisions:

1. Whether the organization is used for a governmental purpose and performs a governmental function;
2. Whether performance of its function is on behalf of one or more states or political subdivisions;
3. Whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner;
4. Whether control and supervision of the organization are vested in public authority or authorities;
5. Whether express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and
6. The degree of financial autonomy and the source of its operating expenses.

See Rev. Rul. 57-128, 1957-1 C.B. 311.

Discussion:

Economic development has historically been a function of the government of State as well as local governments within State. Entity is now responsible for this governmental function under Agreement.

Fund is a State agency created by the legislature of State, operating within a department of State government. Local EDC is created by a municipality of State and reports to the municipality. Entity performs its function on behalf of Fund and Local EDC.

Upon termination of Agreement, any of Entity's assets remaining after payment of Entity's obligations and expenses are to be distributed to Fund, or any statutory successor. In the event that neither Fund nor statutory successor exists, the remaining assets are to be distributed to State. No participants may receive any assets upon termination of Agreement.

The Governor of State appoints up to two-thirds of Entity's board members, and the governing bodies of the respective municipalities which created the EDCs appoint the remaining board members. The Governor of State appoints the members of Entity's executive committee.

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The creation of Entity by means of an agreement between two or more public agencies of State is provided for by State statute (Act 1). In addition, Executive Order of the Governor of State outlined how Entity was to be created and for what purpose.

Entity depends on appropriations from the legislature of State for its funding.

Based on the information submitted, we rule that Entity is a wholly owned instrumentality within the meaning of § 3306(c)(7). Therefore, the services performed by Entity's employees are excluded from employment for FUTA purposes. Accordingly, Entity is not subject to the FUTA tax under § 3301 with respect to wages paid to its employees.

Issue 2:

Section 170(a)(1) of the Code provides, subject to certain limitations, a deduction for contributions and gifts to or for the use of organizations described in § 170(c), payment of which is made within the taxable year.

Section 170(c)(1) of the Code states that the term "charitable contribution" includes a contribution or gift to or for the use of a state, a possession of the United States, any political subdivision of a state or any possession of the United States, the United States, or the District of Columbia, but only if the contribution is made for exclusively public purposes.

The term political subdivision is not defined in the Code. However, § 1.103-1(b) of the Income Tax Regulations provides that "political subdivision" means any division of any state or local government unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit.

An entity that is not a governmental unit specifically described in § 170(c)(1) of the Code may nevertheless qualify to receive deductible charitable contributions if it is an instrumentality of a state or an instrumentality of a political subdivision of a state. See Rev. Rul. 75-359, 1975-2 C.B. 79. Although § 170(c)(1) of the Code does not refer to instrumentalities of a state or instrumentalities of a political subdivision of a state, it is a long-standing position of the Service that contributions or gifts to a state or a political subdivision, or an organization acting on behalf of such entity, that are made for exclusively public purposes are deductible under § 170(c)(1). See Rev. Rul. 79-323, 1979-2 C.B. 106.

Revenue Ruling 57-128, 1957-1 C.B. 311, provides that the following factors are taken into consideration in determining whether an organization is an instrumentality of one or more states or political subdivisions: (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private

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interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses.

These factors have been applied in arriving at a determination that an organization is an instrumentality for purposes of § 170(c)(1) of the Code such that contributions, if made exclusively for public purposes, may be deductible.

Discussion:

For the reasons discussed above, in our analysis of the first issue, we conclude that Entity is an instrumentality of State and political subdivisions of State for purposes of § 170(c)(1). Further, as in Rev. Rul. 79-323, Entity's activities serve a public purpose by promoting the economy of State. Also, there is no evidence of private inurement.

Therefore, based on the information submitted, we conclude that contributions or gifts to or for the use of Entity are charitable contributions as defined in § 170(c)(1) of the Code.

No opinion is expressed about the federal income tax treatment of the transaction under other provisions of the Code.

The above rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that these rulings may not be used or cited as precedent.

A copy of this ruling should be attached to the federal income tax returns of the taxpayers involved for the tax years affected.

Sincerely,

Acting Assistant Chief Counsel  
(Income Tax & Accounting)

By: Michael D. Finley  
Chief, Branch 3

Enclosure:

Copy for § 6110 purposes