

**Internal Revenue Service**

Department of the Treasury

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**LEGEND**

- Taxpayer =
- Statute =
- State =
- Date 1 =
- Date 2 =
- Trust =
- Legislation Year 1 =
- League =
- Trust Agreement =

Dear

This is in response to a letter dated October 4, 1999, and subsequent correspondence, requesting a ruling that (1) the income of Taxpayer is excluded from gross income under § 115 of the Internal Revenue Code; (2) Taxpayer qualifies as a wholly owned instrumentality of a state or political subdivision thereof within the meaning of § 3121(b)(7)(F) for purposes of the OASDI portion of the FICA tax; and (3) Taxpayer qualifies as an instrumentality of a state or political subdivision thereof within the meaning of § 3306(c)(7) for purposes of the FUTA tax.

FACTS

Taxpayer is a risk pool created pursuant to Statute to provide life, sick, accident and other health benefits, and related services, and to perform operations in furtherance thereof for employees, officials and retirees, and their dependents, of

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political subdivisions of State. All members of Taxpayer must be political subdivisions within the meaning of section 1.103-1(b) of the Income Tax Regulations. Taxpayer was established, on Date 1, by the trustees of Trust to continue the operations of Trust, which will terminate on Date 2. Taxpayer is intended to constitute a “voluntary employees’ beneficiary association” within the meaning of § 501(c)(9). Taxpayer has applied to the Internal Revenue Service (the Service) for recognition of exemption as an organization described in § 501(c)(9).

In Year 1, certain cities of State formed Trust as a risk pool organized exclusively to provide life, accident and health insurance benefits for employees of cities and other political subdivision employers of State. Trust received a determination from the Service that it qualified as an organization described in § 501(c)(9).

Trust’s Board of Trustees (Board) is composed of one individual elected from each of 15 geographical regions of State. Board’s members are required to be employees or elected officials of State municipalities. The 15 regions were established by League, an unincorporated association of incorporated cities in State that provides services to its member cities. Board’s members function as employees and officials of their respective municipalities, however, and not as representatives of League.

Political subdivisions are authorized by Legislation to become members of Taxpayer. Employer members of Taxpayer enter into standard interlocal agreements in which they designate Taxpayer as their instrumentality to administer the interlocal agreement and the operation of the risk pool created to provide benefits to their employees. Statute requires that the financial records of a risk pool be audited each year by an independent auditor and the records be open to public inspection. A summary of the financial report is presented to each employer member annually. Statute also provides for payment of contributions and premiums by political subdivisions, or their employees, to fund the benefits provided by the pools. Further, it provides that a pool may be administered by a staff employed by the pool, by an entity created by the political subdivisions participating in the pool, or by a third party administrator.

Taxpayer is governed by a Board of Trustees composed of no more than twenty-two trustees, of which, nineteen are voting trustees and three are ex-officio, non-voting trustees. The voting trustees consist of fifteen trustees elected by their corresponding League region who must be either an employee or an elected official of an incorporated city within that region. Up to four voting trustees may be appointed by the Chairman of the Board of Trustees with the agreement of the remaining trustees. Such appointed trustees must be current or former officials or employees of a political subdivision of State. The ex-officio trustees include the Executive Director of League, or his appointee, a member of the Board of Directors of League, whose city is a member of Taxpayer, and a member of the League Intergovernmental Risk Pool, whose city is a member of Taxpayer.

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In connection with Taxpayer's formation, Taxpayer has been funded with a nominal amount of cash. Taxpayer will also receive the assets and liabilities, after payment of obligations, of Trust, upon its termination. Thereafter, Taxpayer's income will come exclusively from contributions from its member political subdivisions and investment income. Taxpayer will receive income from risk-participating members and members that do not share the risk of providing health benefits.

Trust essentially operates for the purpose of establishing and operating an insurance risk pool. Trust Agreement provides that no part of the net earnings inure to the benefit of any private shareholder or individual. Net earnings are used exclusively to acquire and deliver health insurance and health insurance benefits to Taxpayer's permitted participants. Upon dissolution of Taxpayer, any remaining assets are distributed to the member political subdivisions.

### LAW AND ANALYSIS

Section 115(1) provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or any political subdivision thereof.

Section 1.103-1(b) of the Income Tax Regulations provides that for purposes of that section, the term "political subdivision" means any division of any state or local governmental unit that is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. Rev. Rul. 73-563, 1973-2 C.B. 24, provides that the three generally recognized sovereign powers of states are the police power, the power to tax, and the power of eminent domain. See Alexander J. Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd, 144 F.2d 988 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945).

When determining if § 115(1) applies, the Service considers all the facts and circumstances relating to the organization to determine whether the organization performs an essential governmental function and whether the income of the organization accrues to a state or a political subdivision thereof.

Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization formed, operated, and funded by political subdivisions to pool their casualty risks and other risks arising from their obligations concerning public liability, workers' compensation, or employees' health obligations. The ruling states that the income of such an organization is excluded from gross income under § 115(1) so long as private interests do not participate in the organization or benefit more than incidentally from the organization. The benefit to the employees of the insurance coverage obtained by the member political subdivisions was deemed incidental to the public benefit.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that income from a fund, established under a written declaration of trust by a state, for the temporary investment of positive

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cash balances of a state and its political subdivisions, is excluded from gross income under § 115(1) of the Code. The ruling reasons that the investment of positive cash balances by a state or political subdivision in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and raise revenue.

Taxpayer provides life, sick, accident and other health benefit insurance coverage for employees, officials and retirees, and their dependents, of political subdivisions of State. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Taxpayer performs an essential governmental function within the meaning of § 115(1) of the Code.

Under § 115(1), income of Taxpayer must accrue to states or their political subdivisions. No part of Taxpayer's net earnings inures to the benefit of any private person. In addition, upon distribution or liquidation, Taxpayer's remaining assets must be distributed to its member political subdivisions. Thus, the income of Taxpayer is excluded from gross income under § 115.

Section 501(c)(9) defines a voluntary employees' beneficiary association (VEBA) as an association providing for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries, if no part of the net earnings of the association inures (other than through such payments) to the benefit of any private shareholder or individual.

Sections 3101 and 3111 impose taxes under the Federal Insurance Contributions Act (FICA) on the wages paid by employers to employees with respect to employment. Sections 3101(a) and 3111(a) impose Old-Age, Survivors, and Disability Insurance (OASDI) taxes on the wages of employees. Sections 3101(b) and 3111(b) impose Medicare taxes on the wages of employees. In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment."

Section 3121(b)(7) generally excludes from "employment" services performed in the employ of any state, or any political subdivision thereof, or any wholly owned instrumentality of any one or more of the foregoing. Section 3121(b)(7)(F), effective for services performed after July 1, 1991, excludes from "employment" only the services of an employee of a state, political subdivision, or wholly owned instrumentality thereof that is wholly owned by one or more states or political subdivisions, who is a member of a retirement system.

Taxes under the Federal Unemployment Tax Act (FUTA) apply to wages paid on account of employment. Section 3306(c)(7) excludes from the definition of "employment" for FUTA purposes service performed in the employ of a state or any political subdivision thereof, or any instrumentality of any one or more of the foregoing

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that is wholly owned by one or more states or political subdivisions.

Rev. Rul. 57-128, 1957-1 C.B. 311, holding that a state insurance commission was a wholly owned instrumentality of its founding states, establishes six factors to be considered in determining whether an organization is a wholly owned instrumentality of a state. These factors are as follows: (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.

Taxpayer is used for a governmental purpose and performs a governmental function, as indicated by the fact that the State legislature provided by statute for the creation of risk pools by political subdivisions through Statute and Legislation. See also Rev. Rul. 90-74. By the same token, there was express statutory authority for Taxpayer's creation.

The performance of Taxpayer's function is on behalf of political subdivisions, as required by Statute, and control and supervision of Taxpayer are vested in public authorities. Taxpayer was formed by Board, which is composed of representatives of political subdivisions of State. The majority of the members of Taxpayer's Board of Trustees, like Board, are elected by political subdivisions of the 15 geographical regions of State. Taxpayer's Board of Trustees is, therefore, controlled by officials or employees of State political subdivisions, acting in their official capacities. The three non-voting members of Taxpayer's Board of Trustees are League representatives.

There are no private interests involved in Taxpayer, and political subdivisions have the powers and interests of an owner. Taxpayer is founded by a trust agreement (the Trust Agreement) executed by and between political subdivisions of State as a successor to Trust. Its sole purpose is to provide insurance benefits to employees of State political subdivisions as an organization described in § 501(c)(9). The net earnings of Taxpayer may not inure to the benefit of any private individual or shareholder. Upon revocation or termination of Taxpayer, any assets remaining after payment of its obligations and satisfaction of liabilities to existing beneficiaries must be divided among the employer members that participate in the pool to be used exclusively to continue to provide insurance benefits to employees.

The source of Taxpayer's operating expenses is the participating political subdivisions, or their employees, as provided by Statute. Its purpose is limited solely to providing life, sick, accident, and other health benefits for employees of the member employers.

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Solely on the basis of the information submitted, we find that the Taxpayer has satisfied all of the factors listed in Rev. Rul. 57-128. Accordingly, Taxpayer is an instrumentality of State for purposes of §§ 3121(b)(7) and 3306(c)(7).

### CONCLUSIONS

Based on the information and representations submitted by Taxpayer, we conclude that (1) the income of Taxpayer is excluded from gross income under § 115(1); (2) the services of Taxpayer's employees who are members of a retirement system within the meaning of § 3121(b)(7)(F) do not constitute employment for purposes of the OASDI portion of the FICA tax; and (3) the services of Taxpayer's employees do not constitute employment for purposes of FUTA tax.

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code. Furthermore, no opinion is expressed as to whether the Taxpayer maintains a retirement system within the meaning of § 3121(b)(7)(F) or whether the exception to the Medicare portion of the FICA tax contained in § 3121(u)(2)(C) applies.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the provisions of a power of attorney currently on file, we are sending a copy of this ruling letter to your authorized representative.

Sincerely,  
Assistant Chief Counsel  
(Financial Institutions and Products)  
By: Alvin J. Kraft, Chief, Branch 1

Enclosures:

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Section 6110 Copy