

**Internal Revenue Service**

**Department of the Treasury**

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**Washington, D.C. 20224**

**Person to Contact:**

**Telephone Number:**

**Refer Reply to:**

CC:DOM:FI&P:3/PLR-105942-00

**Date:**

June 30, 2000

LEGEND:

Entity A =

Entity B =

Company =

Government Official =

State X =

State Y =

State Z =

Year 1 =

Year 2 =

Year 3 =

a =

b =

c =

d =

Dear :

This is in response to a March 10, 2000, letter and subsequent correspondence submitted on behalf of Entity A and Entity B requesting a ruling that the income of Entity A and Entity B is excludible from gross income for federal income tax purposes under section 115(1) of the Internal Revenue Code. Entity A and Entity B also have requested a ruling concerning their filing requirements. Pursuant to

PLR-105942-00

section 8.02(1) of Rev. Proc. 2000-1, 2000-1 I.R.B. 4, 28, that ruling will be addressed in a separate response.

FACTS

Entity A:

Entity A was incorporated in Year 1 as a State X not-for-profit corporation. Entity A has received a determination letter from the Service that it is exempt from federal income tax under section 501(c)(3) of the Code.

The purpose of Entity A is the general improvement of city government by the following means: First, the perpetuation of Entity A as an agency for the cooperation of Government Officials, managers, and other designated representatives of cities, in the practical study of all municipal issues; second, the holding of annual and other meetings for the discussion of current city problems; third, the furnishing of information to municipal officials to enable them to better perform their functions; and fourth, the safeguarding of the interests, rights, and privileges of municipalities as they may be affected by legislation.

Entity A also maintains a program that offers an opportunity for other nonprofit organizations to communicate with Government Officials throughout the nation and to stay informed (and offer information) about issues impacting cities. Entities that participate in this program are nonprofit organizations that share issues with municipalities. The objectives of this program are to provide opportunities for issue collaboration between Entity A and the nonprofit community, to bring any specific expertise of other nonprofit organizations to the attention of the government officials, and to present the government officials the perspectives of those nonprofit organizations.

Entity A's Constitution, which serves as its bylaws, describes those cities eligible for membership as municipal corporations of a or over in population. Cities with populations of less than a may participate as "service members," meaning in large part they may elect to be members of Entity A, but have no right to vote. Entity A's Constitution also provides that the capital city of any state which does not otherwise qualify for membership (because its population is less than a) may be invited to participate as a regular member. Only cities may be and are members of Entity A. In no event is any class of membership open to any private individual, firm, or corporation, or other for-profit entity. All members (whether regular

PLR-105942-00

members or service members) are political subdivisions of a state.

Entity A is governed by an Executive Committee, consisting of a President (who holds office for a one-year term), Vice President, Past Presidents, Chairman of the Advisory Board, and b trustees. Each of such members of the Executive Committee (including the trustees) is a Government Official who has been elected to so serve by Entity A's membership. Entity A's membership elects the individuals to office at the annual meeting of Entity A, and they hold office for the designated term, or until successors are elected or qualified.

The Advisory Board of Entity A functions in an advisory capacity to the Executive Committee on matters of policy and program. The Advisory Board is elected at the annual meeting of the members and may consist of not more than c members. As with the members of the Executive Committee, the members of the Advisory Board, all of whom are Government Officials, are elected by the membership.

Day-to-day operations are overseen by the Executive Director, who is appointed by the Executive Committee and holds office at the pleasure of the Executive Committee and the Advisory Board. The Executive Director is charged with the responsibility of transacting the routine and financial business of the organization as may be determined by the Executive Committee and Advisory Board. Those functions are performed by the Executive Director and his or her staff.

Entity A receives operating funds from dues paid by member and service member cities. Other sources of revenue include meeting and conference revenues, royalties, earnings from investments, and contributions and grants from individuals, corporations, private foundations, and other public-sector sources.

Entity A also owns 100 percent of the stock of Company, a for-profit subsidiary. Company was incorporated in State X during Year 2. The activities carried on by Company are limited to the provision of services that support the programs developed by Entity A. Company has not generated any substantial net profits since it was formed. In the event Company were to realize sufficient profits to merit a declaration of dividends, dividends could be declared and paid to Entity A.

All revenues received by Entity A are used for programs and activities engaged in by Entity A. No private individual, association, or corporation has any ownership interest in Entity A's earnings or its assets, and no part

PLR-105942-00

of its earnings inures to the benefit of, or is distributable to, any private entity or individual.

Entity A's Certificate of Organization and Constitution do not include any provision regarding the dissolution of Entity A. Entity A will adopt, as a part of its Certificate of Organization, a dissolution clause that provides upon the dissolution of Entity A, that after payment or provision for payment of all liabilities of Entity A, any remaining assets of Entity A shall be distributed exclusively to cities that are then members of Entity A.

Entity B:

Entity B was incorporated in State Z during Year 3 and is an outgrowth of Entity A. Entity B has also received a determination letter from the Service that it is exempt from federal income tax under section 501(c)(3) of the Code. The purposes of Entity B are the production and dissemination of educational materials and programs relating to urban affairs; the provision of information and technical services to incorporated municipalities in the United States and its possessions; and the enhancement of the delivery and management of urban services by municipalities.

The principal reason for maintaining Entity B as a distinct legal entity from Entity A, is that Entity B's funds are largely derived from federal government grants and contracts. Because of the accounting framework associated with federal grant programs, it has been administratively more efficient to maintain Entity B as an entity separate from, but related to, Entity A. The objectives of the two organizations, however, are similar.

Entity B is a nonprofit corporation having one member, Entity A. Membership is not open to any individual, association, or corporation. Governance of Entity B is carried out by its Board of Directors. The members of the Board of Directors (there are d directors) are elected by Entity A as the sole member of Entity B. Any Director may be removed at any time, with or without cause, by Entity A.

The Board of Directors is authorized, among other things, to approve educational programs relating to urban affairs and municipal administration. The Board may not exercise its authority in a manner inconsistent with Entity B's Articles of Incorporation or its Bylaws. Officers of Entity B are chosen by the Board of Directors, and have such powers and duties as prescribed by the Board.

Entity B's income is largely derived from federal government grants. Entity B also receives nominal amounts

PLR-105942-00

of program service revenue and income from investments. All revenues of Entity B are spent on and in connection with the projects designated pursuant to the federal grants.

The Articles of Incorporation for Entity B provide that there shall be no pecuniary gain, incidentally or otherwise, to its member. Further, all assets and earnings are required to be distributed, used, and applied for the purposes for which Entity B was created, and no part of the net earnings of Entity B shall inure to the benefit of any private organization or individual. Entity B will adopt a new dissolution clause, to be reflected in an amendment to the Articles of Incorporation and in the Bylaws. The new provision will require that, upon dissolution of Entity B, and after payment or provision for payment of all liabilities of Entity B, any remaining assets of Entity B shall be distributed exclusively for public purposes to municipalities constituting political subdivisions of a state (or the District of Columbia) within the meaning of section 115(1) of the Code. In no event may any assets of Entity B vest in or be distributed to any private organization or individual.

#### LAW AND ANALYSIS

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

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 of the state.

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. The revenue 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.

PLR-105942-00

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 cash balances of a state and its political subdivisions, is excludable 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.

Entity A was created to further the legitimate governmental and public functions of member municipalities. Entity B was formed to further the purposes of Entity A. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Entity A and Entity B perform essential governmental functions within the meaning of § 115(1) of the Code.

In addition to the performance of an essential governmental function, for Entity A and Entity B to qualify to exclude their income from gross income under § 115(1) of the Code, income of Entity A and Entity B must accrue to a state or to a political subdivision of a state.

Entity A's proposed amendments to its Certificate of Organization include a dissolution clause that provides upon the dissolution of Entity A, that after payment or provision for payment of all liabilities of Entity A, any remaining assets of Entity A shall be distributed exclusively to municipalities that are then members of Entity A. Only municipalities can be members of Entity A, which are all political subdivisions of a state. Accordingly, the income of Entity A is excludible from gross income under § 115(1) of the Code.

Entity B's proposed amendments to its Articles of Incorporation and Bylaws include a dissolution clause that provides upon dissolution of Entity B, and after payment or provision for payment of all liabilities of Entity B, any remaining assets of Entity B shall be distributed exclusively for public purposes to municipalities constituting political subdivisions of a state (or the District of Columbia) within the meaning of section 115(1) of the Code. Accordingly, the income of Entity B is excludible from gross income under § 115(1) of the Code.

#### HOLDING

Based on the information and representations submitted by Entity A, and provided that Entity A adopts in final form the proposed amendments to its Certificate of Organization

PLR-105942-00

as described above, we hold that the income of Entity A is excludible from gross income for federal income tax purposes under § 115(1) of the Code.

Based on the information and representations submitted by Entity B, and provided that Entity B adopts in final form the proposed amendments to its Articles and Bylaws as described above, we hold that the income of Entity B is excludible from gross income for federal income tax purposes under § 115(1) of the Code.

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.

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

Sincerely yours,  
Assistant Chief Counsel  
(Financial Institutions and Products)  
By: Alice M. Bennett  
Chief, Branch 3

Enclosures:

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