

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Legend

Corporation = _____
X = _____
Act = _____
Department = _____

Committee = _____
Program = _____
z years – _____

Dear _____

This is in response to your letter, dated May 19, 2003, requesting a ruling that the income of Corporation will be excludable from gross income under section 115 of the Internal Revenue Code (“Code”).

FACTS

Corporation was incorporated as a nonprofit organization in X as a non-stock captive mutual insurance company under Act, for the purpose of providing reinsurance, insurance, and excess insurance to municipalities, counties, schools, and other public entities. Corporation has been granted authority to operate as a multi-line reinsurance company by Department.

Corporation enables public entities to secure stable and affordable reinsurance and insurance protection. Corporation provides coverage for such needs as workers’ compensation, property coverage, employee benefits and liability reinsurance. Members of Corporation are municipalities, counties, public schools, public entity self-insured groups, and risk pools and captive insurers of public entities. Each member is an owner of Corporation and net income is returned to the member-owner. Corporation

will not provide insurance to any entity other than the public entities which are its members.

Corporation is the outgrowth of Committee, composed of public entity representatives with experience in self-insurance, pooling and insurance. Committee was formed by Program, a nonprofit corporation whose members are governments, government agencies, public agencies, publicly chartered corporations, and organizations described in section 115 of the Code. Program allocated funds for the development of Corporation as a captive insurance company because such an entity would provide added benefits to the member public entities. Such benefits included the ability to specialize in the coverage needs of public entities, the ability to retain for the benefit of members any underwriting net income resulting from favorable loss experience, increased access to the reinsurance market, and investment income from loss reserves held for the benefit of public entity members.

Corporation is controlled by its member public entities and all major decisions regarding the operation of the Corporation are made by the members. Corporation currently has seven directors, who are elected by the member public entities. Each director must be a designated representative of a member, with the exception of two outside directors with management or consultant experience in captive insurance company or risk pool operations.

Participation in the Corporation is governed by a membership agreement. Under the membership agreement, Corporation's capitalization comes from surplus contributions of its public entity members. In order to become a member, each public entity must remit both a premium payment and a surplus contribution. The surplus assures the long-term financial solvency of Corporation. Additional surplus contributions may be requested of members from time to time, as necessary to maintain adequate premium to surplus ratios, to cover unexpected losses and to comply with statutory and regulatory requirements. Each member is also required to pay annual premiums.

Any net income retained by the Corporation at the end of each fiscal year is added to the surplus, reduces premium payments, or is distributed to member public entities in the form of dividends. The membership agreement also provides for a surplus account for each member public entity. This account serves as a continuous accounting of each member's interest in and ownership of the net earnings of the Corporation. Each member is entitled to a return of its surplus account upon withdrawal from the Corporation, with certain limitations. As long as a withdrawing member has participated in the Corporation for z years, it will receive a return of its initial surplus contribution and any additional surplus contribution.

Upon dissolution of Corporation, the assets will be liquidated and distributed to the member public entities, after payment of liabilities and expenses.

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 section 115(1) of the Code applies, the Service considers all the facts and circumstances relating to the organization to determine: (1) whether the organization performs an essential governmental function, and (2) whether the income of the organization accrues to a state or political subdivision of a state. The determination whether a function is an essential governmental function depends on the facts and circumstances of each case.

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 section 115(1) of the Code 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, 1977-1 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 section 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.

The Corporation was established to provide insurance and reinsurance for its members against liabilities arising from the conduct of governmental functions by member political entities and their employees. By obtaining insurance on a risk-sharing basis, the member public entities are carrying out their obligation to protect their financial integrity and protect their employees from liability while acting within their official duties. Any private benefit to employees is incidental to the public benefit. Corporation was created to further the legitimate governmental public functions of its member public entities. Based on Rev. Rul. 90-74 and Rev. Rul. 77-261, Corporation

performs an essential government function within the meaning of section 115(1) of the Code.

In addition to the performance of an essential governmental function, for Corporation to qualify to exclude its income from gross income under section 115(1) of the Code, income of Corporation must accrue to State or a political subdivision of State.

Corporation is owned by public entities, all of which are municipalities, counties, schools, public entity self-insured groups, risk pools and captive insurers of public entities. As such, all members of Corporation are political subdivisions or section 115 entities. No part of the net earnings of the Corporation inures to the benefit of or is distributed to a private entity or individual. Upon dissolution of the Corporation, all of its net assets will be distributed to the member public entities. Accordingly, the income of Corporation accrues to a State or a political subdivision of a State.

CONCLUSION

Based on the information and representations submitted by Corporation, we hold that the income of Corporation is excludable from gross income for federal income tax purposes under section 115(1) of the Code.

No opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Code.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Barbara E. Beckman, Assistant Chief
Exempt Organizations Branch 2
Office of Division Counsel/Associate Chief
Counsel
(Tax Exempt and Government Entities)

Enclosure: Copy of this letter
Copy for 6110 purposes