

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

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Refer Reply To:

CC:TEGE:EOEG:ET2 –PLR-
166270-03

Date:

March 30, 2004

Legend

State A -

X -

Y -

Z -

Date 1 -

Date 2 -

Date 3 -

Date 4 -

Date 5 -

Date 6 -

Date 7 -

Date 8 -

Date 9 -

Date 10 -

Chapter 1 -

Chapter 2 -

Chapter 3 -

Chapter 4 -

Chapter 5 -

Dear :

PLR-166270-03

This is in response to your request for rulings dated _____ and received in our office on _____. The two issues for which rulings are requested are as follows:

(1) Whether Z's income is excludable from gross income under Internal Revenue Code (Code) section 115.

(2) Whether the wages Z pays its employees are exempt from taxes under the Federal Unemployment Tax Act (FUTA) because services performed in the employ of Z are excepted from the term "employment" pursuant to Code section 3306(c)(7).

Facts

State A General Statutes Chapter 1 provides that a municipality shall have among other powers the power to construct, equip, operate, and maintain hospital facilities. X is a general acute care hospital located in Y. X was created and continuously operated pursuant to a resolution of the Y Board of Commissioners (Commissioners), dated Date 1. Pursuant to the resolution, the Y Commissioners appointed individuals to the hospital's Board of Trustees (Trustees) to manage and direct the affairs of X. By letter dated Date 2, the Internal Revenue Service (IRS) held that X was a wholly-owned instrumentality of a political subdivision of State A, and that, as such, services performed in its employ were excepted from "employment" under Code section 3306(c)(7). By letter dated Date 3, the IRS held that X was exempt from federal income taxes as an organization described in Code section 501(c)(3).

On Date 4, the Commissioners of Y passed a resolution calling for the organization of a new nonprofit corporation to promote and advance health care in Y. The resolution provided for the creation of Z. The resolution also provided for the transfer to Z of X's equipment and intangible property and the execution of a lease to Z for X's real property. On Date 5, designated Y Commissioners, acting as incorporators, signed Z's Articles of Incorporation (Articles). On Date 8, X, Y, and Z entered into an Agreement for the Reorganization of X pursuant to which X leased the real property to Z and transferred the operating assets of X to Z in accordance with Chapter 2 of the State A General Statutes and specifically State A General Statute Chapter 5. On Date 6, Z's Articles were filed with the State A Secretary of State. Articles of Amendment were filed on Date 9 and Date 10.

Article III of the Articles provides that Z is a charitable corporation and its purpose is to promote and advance health care related activities, services and purposes primarily within, and for the benefit of residents of Y. Article IV provides that the sole member of Z is Y acting by and through the Y Commissioners, and the membership of Y in Z is not subject to termination or transfer.

PLR-166270-03

Article V of the Articles provides that Z shall be governed by a Board of Directors (Board) who shall be known as Trustees. The Board is comprised of eleven voting Trustees, ten of whom are not Y Commissioners, and one of whom may be a Y Commissioner, and an indeterminate number of ex-officio non-voting members. Article V also provides that the Trustees serve at the pleasure of the Y Commissioners, and may be removed by the Commissioners at any time with or without cause.

On Date 7 the Commissioners passed a resolution ratifying the creation of Z and approving and authorizing, subject to certain conditions, the transfer to Z of the equipment and tangible property of X.

Article VII of the Articles provides that no part of the net earnings of Z shall inure to the benefit of or be distributable to its trustees, officers, or other private persons, except that Z shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the promotion and advance of health care related activities, services and purposes primarily within, and for the benefit of residents of Y. Article VII also provides that Z is not permitted to carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under Code section 501(c)(3), (b) by a corporation contributions to which are deductible under section 170(c)(2), or (c) by a corporation eligible to exclude income under section 115.

Article IX, as amended effective Date 9, provides that in the event of dissolution or liquidation of Z, after paying or adequately providing for the debts and obligations of Z, the Trustees shall donate, transfer, deliver and convey all of its moneys, properties, and other assets: (a) to any successor organization having purposes which are similar to the existing corporation's purposes, provided that the successor organization is exempt from taxation under Code section 501(c)(3) and the successor corporation and the donation, transfer, delivery and conveyance to it are approved in writing by the Y Commissioners; or (b) if there is no successor corporation, then to Y or a governmental entity described in Code section 115 created by Y for exclusively public purposes.

Law and Analysis

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

Revenue Ruling 77-261, 1977-2 C.B. 45, concludes that income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, is

PLR-166270-03

excludable from gross income under Code section 115(1). The revenue ruling reasons that the investment of positive cash balances by a state or political subdivision thereof, 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. Revenue Ruling 77-261 points out that Congress did not desire in any way to restrict a state's participation in enterprises which might be useful in carrying out those projects desirable for the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct.

Revenue Ruling 90-74, 1990-2 C.B. 34, concerns an organization that is formed, operated, and funded by political subdivisions to pool their casualty risks arising from their obligations concerning public liability, workers' compensation, or employees' health. Revenue Ruling 90-74 states that the income of the organization is excluded from gross income under Code section 115(1) if private interests do not participate in the organization or benefit more than incidentally from the organization. In Revenue Ruling 90-74, the benefit to the employees of the political subdivisions was excepted as incidental. Furthermore, upon dissolution, the organization will distribute its assets to its members. Therefore income of the organization accrues to a political subdivision within the meaning of section 115(1).

Revenue Ruling 71-589, 1971-2 C.B. 94, provides that the income from property held in trust by a city, which was to be used by the city for certain charitable purposes, is not subject to federal income tax. Although Revenue Ruling 71-589 does not explicitly so state, its holding is based on a determination that the income in question was derived from the exercise of an essential governmental function and accrued to a political subdivision within the meaning of Code section 115(1). Revenue Ruling 71-589 specifically mentions several types of functions that the trust might perform, such as support of a hospital, schools, maintenance of a park, or other purpose ordinarily recognized as a municipal function.

In order for Z's income to be excludable, it must meet the two-part test set forth in Code section 115(1). Promotion of health and the support of medical facilities are well-established functions of governments. Therefore, Z is performing an essential governmental function. Further, the assets and income of Z accrue only to Y, a political subdivision of State A and the sole member of Z. In addition, upon dissolution, all remaining assets are to be transferred to Y, or to a governmental entity described in Code section 115 and created by Y for exclusively public purposes. Therefore, the income of Z accrues to Y.

Code section 3306(c)(7) provides that, for purposes of the FUTA tax, "employment" does not include service performed in the employ of a State, or any political subdivision

PLR-166270-03

thereof, or any instrumentality of any one or more of the foregoing 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, that organization is not required to pay FUTA tax.

Revenue Ruling 57-128, 1957-1 C.B. 311, provides six factors to be considered 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 interests involved, or whether the state or political subdivisions 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.

Each of these factors must be evaluated in order to determine if Z is an instrumentality of Y which is a political subdivision of State A.

Z satisfies the first factor of Rev. Rul. 57-128 insofar as it has a governmental purpose and performs a legitimate governmental function. State A General Statutes Chapter 3 authorizes municipalities to construct, operate and maintain hospitals and other facilities which furnish hospital, clinical and similar services to the people of State A. General Statute Chapter 4 provides that the word "municipality" includes any county, city, or other political subdivision of State A. Y satisfies this definition. Y performs a governmental function in that it provides public medical care for residents of Y. It provides this function on behalf of Y, a political subdivision of State A. Support of a hospital is generally recognized as a municipal function.

Z also satisfies the second factor, performance of functions on behalf of a political subdivision. Article III of Z's Articles provides that Z is a charitable corporation which is organized to promote and advance health care related activities, services and purposes primarily within, and for the benefit of the residents of Y. Z performs its functions on behalf of Y, a political subdivision of State A.

Z also satisfies the third factor insofar as Y, a political subdivision, has the powers and

PLR-166270-03

interests of an owner of Z. Article IV of Z's Articles provides that the sole member of Z is Y acting by and through its Commissioners. Article V provides that Z is governed by a Board. Board members are appointed by Y Commissioners and may be removed at any time with or without cause. Article 5, section 8 of the by-laws provides for an annual audit conducted in compliance with section 2.7(a) of the Lease Agreement. According to Lease Agreement section 2.7(a), Z will have an annual financial audit performed by a nationally recognized firm of independent auditors and accounting consultants, to include a review of compliance by Z with the lease provisions, and such audit will be provided to Y. Y also has the right to review other financial information with respect to Z. Accordingly, Y has the powers and interests of an owner.

The fourth factor in Rev. Rul. 57-128 requires control to be vested in public authority or authorities. Article V of the Articles of Incorporation provides that control and supervision of Z is vested in the Z Board, each member of which serves at the pleasure of the Y Commissioners and may be removed by the Y Commissioners at any time with or without cause. Article VIII places significant restrictions on Z with respect to the disposition and management of its assets and health care related facilities unless such matters are agreed to by the Y Commissioners. Accordingly, control and supervision of Z is vested in the Y Commissioners.

Z satisfies the fifth factor of Rev. Rul. 57-128 because express statutory authority exists for the transfer of assets and operations from X to Z. Such authority for the transfer is found in Chapter 3 of the State A General Statutes which provides for the sale of a municipality's hospital facilities to nonprofit corporations.

Finally, the sixth factor, which considers the degree of financial autonomy and the source of operating expenses is also satisfied. The operating expenses of Z are paid from the operating income of Z. Z's Article IX was amended July 25, 2001, to provide that upon dissolution or liquidation of Z, any remaining assets of Z are to be transferred to Y or to a governmental entity described in IRC section 115 created by Y for exclusively public purposes. Z is funded out of its operating income and is financially autonomous.

Z satisfies each of the factors listed in Revenue Ruling 57-128. Accordingly, Z is an instrumentality of a political subdivision within the meaning of Code section 3306(c)(7). Thus, services performed in the employ of Z are excepted from the term "employment" for purposes of FUTA taxes pursuant to Code section 3306(c)(7).

Conclusion

Therefore, based solely on the information submitted, we rule as follows.

PLR-166270-03

1. The income of Z will be excluded from gross income under Code section 115.
2. Services performed in the employ of Z are excepted from the term "employment" for purposes of the FUTA, pursuant to Code section 3306(c)(7). Accordingly, Z is not subject to FUTA taxes with respect to wages it pays its employees.

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

The original of this ruling is being sent to your authorized representative as instructed by Form 2848, Power of Attorney and Declaration of Representative.

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Office of the Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

cc: