

Internal Revenue Service

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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PLR-108779-23

Date:
October 18, 2023

LEGEND

Agreement =
Authority =
Counties =
State =
Taxpayer =
X =
Year 1 =
Year 2 =

Dear :

This letter responds to a letter from your authorized representative dated April 3, 2023, and supplemental documentation dated August 7, 2023, and August 25, 2023, requesting a ruling under section 115(1) of the Internal Revenue Code.¹

FACTS

Taxpayer was formed by Authority in Year 1 as a State nonprofit corporation, is a wholly owned subsidiary of Authority, and is recognized by State's insurance department as a captive insurance company. Authority is an unincorporated agency formed in Year 2 under the Agreement. Authority's bylaws restrict its membership to the X Counties that signed the Agreement and any future Counties that sign the agreement.

Authority's purpose is to enable the Counties to share risk, pool reserves, or otherwise secure insurance. Authority administers a self-insurance pool that provides the Counties with an initial level of coverage with respect to their insured risks. If this initial level of

¹ Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

coverage is insufficient, Authority also maintains reinsurance policies through commercial insurers for the balance of the coverage needs. Authority created Taxpayer to operate as a captive insurance company to assist with Authority's reinsurance needs. Taxpayer provides reinsurance to the Counties pursuant to risk-specific agreements under which Taxpayer agrees to provide reinsurance in exchange for annual premiums. The premiums are invested to produce additional income used to pay claims and cover operational expenses. Premiums and investment income are Taxpayer's only sources of income.

Taxpayer and Authority each pay professional service providers for services necessary to conduct their respective operations. These services include actuarial, legal, and audit services. Payments are also made to vendors for risk minimization training courses offered to the Counties and to third-party insurers for commercial reinsurance policies. All service providers and vendors are unrelated to Taxpayer and Authority, and all payments are at arm's length for fair market value. Additionally, Taxpayer and Authority are permitted to reimburse reasonable expenses incurred by members of their respective boards of directors to attend meetings.

Taxpayer's articles of incorporation provide that Taxpayer's net assets are distributable to its sole shareholder, Authority, upon dissolution. The Agreement provides that upon Authority's dissolution, its property is distributable to its members (the Counties).

RULING REQUESTED

Taxpayer's income is excludable from gross income under section 115(1) because Taxpayer's income is derived from its exercise of an essential governmental function and such income accrues to a state or any political subdivision thereof.

LAW AND ANALYSIS

Section 115(1) 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 any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, the Internal Revenue Service ruled that income generated by an investment fund established by a state for the temporary investment of cash balances of the state and its political subdivisions is excludable from gross income under section 115(1) because such investment constitutes an essential governmental function and the fund's income accrues to the state and political subdivisions thereof. The ruling explains that section 115(1) is intended to apply not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of an entity engaged in the operation of a public utility or the performance of some governmental function that accrues to a state or political subdivisions thereof.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Internal Revenue Service ruled that the income of an organization formed, funded, and operated by political subdivisions to pool their casualty risks or other risks arising from obligations concerning public liability, workers' compensation, and employees' health is excludable from gross income under section 115(1) because: 1) pooling risks of political subdivisions constitutes an essential governmental function; 2) except for certain incidental benefits, private interests do not participate in or benefit from the organization; and 3) the organization's income accrues to political subdivisions.

By providing reinsurance to political subdivisions, Taxpayer performs an essential governmental function. See Rev. Rul. 90-74. And because Taxpayer's net assets are distributable to Authority upon Taxpayer's dissolution, and Authority's property is distributable to its members (the Counties) upon Authority's dissolution, Taxpayer's income accrues to political subdivisions. Additionally, private interests do not benefit from Taxpayer's activities or Authority's activities more than incidentally.

RULING

Taxpayer's income is excludable from gross income under section 115(1) because Taxpayer's income is derived from its exercise of an essential governmental function and such income accrues to a state or any political subdivision thereof.

The ruling contained in this letter is based upon information and representations submitted by or on behalf of Taxpayer and accompanied by penalties of perjury statements executed by an individual with authority to bind Taxpayer and upon the understanding that there will be no material changes in the facts. See Rev. Proc. 2023-1 § 7.01(16), 2023-1 I.R.B. 1. This office has not verified any of the materials submitted in support of the request for this ruling, and such materials are subject to verification on examination. The Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) will revoke or modify a letter ruling and apply the revocation retroactively if: 1) there has been a misstatement or omission of controlling facts; 2) the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling was based; or 3) the transaction involves a continuing action or series of actions and the controlling facts change during the course of the transaction. See Rev. Proc. 2023-1 § 11.05, 2023-1 I.R.B. 1.

This letter does not address the applicability of any section of the Code or regulations thereunder other than those sections specifically described. Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any fact or issue discussed or referenced in this letter. Specifically, no opinions are expressed regarding whether Authority is a political subdivision or whether Authority or Taxpayer provides insurance or reinsurance or is an insurance company for federal income tax purposes.

This letter is directed only to Taxpayer. Section 6110(k)(3) 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 Taxpayer's authorized representatives.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Randall Thomas
Senior Counsel
Exempt Organizations Branch 2
(Employee Benefits, Exempt Organizations, and
Employment Taxes)

cc: