INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

OCT 13 1998

Index Number: 115.02-00
Control Number: TAM-112798-97

District Director:

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification Number:
Year Involved:
Date of Conference:

LEGEND:

Year 1 =

State A =

Area =

Statute =

Association =

Year 2 =

Fund =

a =

b =

c =

Date 1 =

d =

Department =

A =

22

B =

C =

Trust Company =

Month 1 =

Year 3 =

e =

f =

g =

h =

i =

j =

k =

ISSUES:

1) Is Fund an integral part of State A for federal income tax purposes?

2) If Fund is not an integral part of State A, is Fund's income excludable from gross income under § 115(1) of the Internal Revenue Code?

CONCLUSIONS:

1) Fund is not an integral part of State A.

2) Fund's income is not excludable from gross income under § 115(1).

22

FACTS:

In Year 1, the State A legislature enacted Statute, which created Association to provide windstorm and hail damage insurance for Area. Every insurer authorized to sell property insurance in State A is required to be a member of Association and to share in Association's gains and losses to the extent of its share of business written in State A in the preceding year. Department and C are responsible for maintaining regulatory oversight of Association, including periodic examinations of the accounts, books, and records of Association. Under certain circumstances (described below), loss payments by members of Association can give rise to State A premium tax credits.

In Year 2, the State A legislature amended Statute to provide that Association either establish a reinsurance program or enter into a contract with Department to create Fund. Pursuant to this mandate, Association and Department created Fund. Fund, which is not incorporated under State A law, is a separate and distinct fund outside the State A treasury to protect policyholders of Association and to reduce the potential for payments by members of Association in the event of losses. Fund is not subject to State A appropriation and budget rules.

Pursuant to the amended Statute, Association entered into an agreement (Agreement 1) with Department under which Association members annually relinquish their "net equity" in Association. In general, the members' net equity is the excess of all premiums and other revenue of Association over its incurred losses and operating expenses. Department, through C, is responsible for ensuring that all funds received from Association are deposited in Fund. Association may terminate the agreement on 60 days written notice to Department.

Fund is maintained by A through Trust Company on behalf of and in trust for the benefit of Department pursuant to an agreement (Agreement 2) between Association, Department, A, and B. Legal title to assets in Fund is in Department. A is the custodian of Fund. A is required to administer Fund strictly and solely as provided by the agreement, and State A cannot take any action with respect to Fund other than as specified under Statute and the agreement. Fund is managed by Trust Company, a special purpose trust company organized under State A law. Trust Company uses State A employees and is accountable to Department. Costs associated with managing funds are deducted from Fund's investment income by Trust Company.

Except upon dissolution of Fund, C cannot certify the

release of Fund assets for any purpose other than payment of losses of insureds of Association to the extent that ultimate net losses from all loss events exceed $b in a calendar year. B will assist C and Department in administrating Fund in the event that any disbursements are necessary from Fund. Upon dissolution of Fund, the assets of Fund revert to Association, which is required by Statute to establish a reinsurance program that is approved by C.

Association has agreed to indemnify and hold harmless A, Trust Company, B, Department and their respective employees, agents, and representatives in consideration of the obligations undertaken by those parties from all claims, judgments, and liabilities arising out of claims or the handling of claims by Association from any loss event.

In Month 1, Fund received $a as its initial funding. This funding was from amounts held by or on behalf of Association. State A has not made any direct or indirect cash contribution to Fund since its inception. As of Date 1, Fund's deposits with Trust Company have grown to $d.

Statute provides an ordered source of payments in the event that an occurrence or series of occurrences results in insured losses in excess of premiums and other revenue of Association. Currently, the excess losses are to be paid in the following manner:

1) $b is assessed to Association members;
2) any losses in excess of $b are to be paid from Fund;
3) any losses in excess of 1) and 2) are assessed to Association members, up to an additional $c; and
4) any losses in excess of 1), 2), and 3) are assessed to Association members.

Any amount paid by an Association member under tier four above may be used as a non-refundable credit against the current and future premium tax payable by the member to State A.

The sum of the net premiums earned, investment income, and other revenue of Association from Year 2 through Year 3 equaled $e. For the same period, Association's loss and loss adjustment expenses and other underwriting expenses (exclusive of net equity contributed to Fund) equaled $f. For each year during the period, the sum of Association's net premiums earned, investment income, and other revenue exceeded the sum of its loss and loss adjustment expenses and other underwriting costs (exclusive of

net equity contributed to Fund) by $g, h, $i, $j, and $k, respectively. Accordingly, there have been no occurrences resulting in excess losses since Year 2, and, therefore, Association members have never been assessed under the statutory payout scheme described above.

LAW AND ANALYSIS:

Integral Part

Income earned by a State or a political subdivision of a State is generally not taxable in the absence of specific statutory authorization to tax such income. See Rev. Rul. 87-2, 1987-1 C.B. 18; § 511(a)(2)(B); GCM 14407, XIV-1 C.B. 103 (1935), superseded by Rev. Rul. 71-131, 1971-1 C.B. 28.

In Maryland Savings-Share Ins. Corp. v. United States, 308 F. Supp. 761 (D. Md. 1970), rev'd on other grounds, 400 U.S. 4 (1970) ("MSSIC"), the State of Maryland formed a corporation to insure the customer accounts of State chartered savings and loan associations. The full faith and credit of the State was not pledged for MSSIC's obligations. The district court rejected MSSIC's claim of tax immunity because the State had neither a present interest in the income of MSSIC nor a financial commitment to MSSIC. Although the district court was reversed on other grounds, the Supreme Court agreed with the lower court's analysis of the tax issue. The Supreme Court rejected MSSIC's position that, ". . . it is an instrumentality of the State and hence entitled to exemption from federal taxation under the doctrine of intergovernmental immunity and under § 115(a)(1) of the Code." MSSIC, 400 U.S. at 7 n.2.

In Michigan v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992), the Sixth Circuit held that the investment income of the Michigan Education Trust (MET) was not subject to current taxation under § 11(a). The court's opinion is internally inconsistent because it concludes that MET qualifies as a political subdivision of the State of Michigan (Id. at 825), that MET is "in a broad sense" a municipal corporation (Id. at 826), and that MET is in any event an integral part of the State of Michigan (Id. at 829).

Whether an enterprise is an integral part of a State depends on the State's relationship to the enterprise. Primary among the factors to consider are (a) whether the State has made a substantial financial commitment to the enterprise, and (b) the State's degree of control over the enterprise.

Although it is not a case involving federal taxation, Texas Catastrophe Property Ins. Ass'n v. Morales, 975 F.2d 1178 (5th Cir. 1992), is instructive as to whether an entity is part of a State. In Texas, the plaintiff association sought injunctive relief challenging a State statute requiring the association to be represented by the Texas attorney general in civil actions. The association, a type of assigned risk pool, was created by a Texas statute that requires all insurers in the State to belong to the association as a condition of doing business in the State. The association writes its own policies and pays its own claims. It is directly funded by the private monies of citizens and corporations rather than from the public treasury.

By statute, the association in Texas operates pursuant to rulemaking procedures adopted by the Texas Board of Insurance with the advice of the association's Board of Directors. Members of the representative insurance companies comprise a majority of the Board of Directors. An act of the Texas legislature proclaimed the association to be a State agency for purposes of employing or authorizing legal representation.

The court in Texas determined that the relevant inquiry is whether the association is part of the State. In support of its conclusion that the association is not part of the State, the court cited the fact that if the association makes a profit, that money does not go to the State. If losses exceed premiums, the member companies are assessed, not the State. The fact that losses are subsidized in part through the allowance of tax credits does not eliminate the risk to the private entities' capital. The court stated:

> [t]hat the state holds, and exercises, the coercive power to force private insurers doing business in Texas to cover certain risks does not mean that the money coming out of the companies' bank accounts is state money. It is private money directed to pay private claims.

975 F.2d at 1182-1183 (footnote omitted).

In the present case, State A exercises significant control over Fund. A, B, C, Trust Company and their employees administer Fund and are responsible for various duties including depositing, protecting, and disbursing funds for Association and its members. Upon dissolution of Fund, the use of the funds in Fund by Association is subject to the approval of C. Accordingly, the control held by State A over Fund satisfies the control portion of the test for integral part status.

State A has not, however, satisfied the substantial

financial commitment portion of the test for integral part status. All of the money being deposited in Fund comes from private sources, the member companies of Association. State A has neither provided seed money for Fund nor does it provide money or financing for the current operations of Fund. Although it is argued that the potential tax credit claims under tier four of the loss payment scheme established by Statute represents a substantial financial commitment by State A, to date tier four has not resulted in any loss of funds or contribution by State A by reason of a reduction in taxes collected by State A. Since the inception of Fund, there have been no claims for tax credits, and, therefore, no State A financial involvement in Fund as a result of tier four. In fact, the losses experienced by Association since Year 2 have never been significant enough to require assessments of members under the first tier of the statutory excess loss payout scheme. Thus, to date State A's financial commitment to Fund has been insignificant. Furthermore, as Fund continues to grow, the likelihood of tax credit claims becomes more remote.

Like the situation in the Texas case, the fact that State A statutorily created and administers a mechanism, as described above, to reduce the risk of major losses to the insureds of Association and Association members in the event of a catastrophe does not cause that mechanism, or any portion of it, to become an integral part of State A for federal income tax purposes. Through the end of Year 3, there have not been any payments from Fund resulting from losses. The fact that the mechanism may at some indefinite future time result in the State A treasury not receiving certain funds because of tax credits available to Association members does not constitute a substantial financial commitment by State A that would cause Fund to be considered an integral part of State A.

Section 115

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 of a State. Section 115(1) applies to an enterprise that is neither an integral part of a State nor of a political subdivision.

Rev. Rul. 71-589, 1971-2 C.B. 94, provides that the income from property held in trust by a city that was to be used by the city for certain charitable purposes is not subject to federal income tax. Although Rev. Rul. 71-589 does not explicitly so

state, its rationale appears to be that the income in question was derived from the exercise of an essential governmental function and that it accrued to a political subdivision within the meaning of § 115(1). The revenue ruling specifically mentions several types of functions that the trust might perform, such as support of a hospital, schools, maintenance of a park, or other purposes ordinarily recognized as municipal functions.

Rev. Rul. 90-74, 1990-2 C.B. 34, holds that income of an organization formed, operated, and funded by political subdivisions of a State to pool their casualty risks is excludable from gross income under § 115(1). The revenue ruling also holds that income of such an organization formed to pool risks in lieu of purchasing insurance to cover the political subdivisions' liability, workers' compensation, or employees' health obligations is excludable under § 115(1) if private interests do not, except for incidental benefits to employees of the participating State and political subdivisions, participate in or benefit from the organization.

The present case is distinguishable from Rev. Rul. 90-74. In Rev. Rul. 90-74, the organization was created to provide political subdivisions an economical means of pooling their casualty and other risks. Although private individuals received an incidental benefit, the primary beneficiaries of the coverage were the political subdivisions of the State. In the present case, Fund fails to satisfy the requirement for exclusion of income under § 115(1) that income accrue to a State or any political subdivision thereof. Association can draw upon Fund if Association's annual revenues plus $b are insufficient to cover losses covered by its policies in that year. Losses on Association's policies in excess of Association's annual revenues plus $b are paid by Fund until its assets are exhausted, thus reducing additional amounts assessable against Association's members pursuant to tiers 3 and 4 described above. Accordingly, Fund benefits Association's members and policyholders because its assets are designed to be used to pay claims of Association's policyholders, which will reduce the likelihood and amount of future assessments on Association's members as described above. Fund's income, therefore, accrues to the benefit of Association's members and policyholders, not to State A or any political subdivision thereof.

Fund contends that the State A legislature could modify Statute in the future, and cause some or all of Fund's income and assets to be deposited in State A's treasury to be used for State A purposes. However, this possibility of future legislation is too remote and hypothetical to be considered for purposes of determining whether Fund's income accrues to State A.

Accordingly, the income of Fund is not excludable from the gross income of Fund under § 115(1).

CAVEAT

A copy of this technical advice memorandum is to be given to Fund. Section 6110(k)(3) provides that it may not be used or cited as precedent.