Internal Revenue Service

Department of the Treasury

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Person to Contact:

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January 12, 2001

Legend

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This letter is in response to a request submitted by your representative on August 24, 2000, as amended by letters dated September 5, 2000 and January 9, 2001, for a ruling that the District is an integral part of City.

FACTS AND REPRESENTATIONS

The District was formed by City pursuant to the Act, as amended in the year X. State enacted Act for the purpose of encouraging certain cities whose tax rates are near their limit to provide needed services in specific geographic areas within municipalities through the formation of assessment-based neighborhood districts. On Y, City, through a City Council Resolution, established the District. The Resolution specifically empowered the District to form a membership corporation for the purpose of providing any and all administrative services within the A neighborhood authorized under the Act, and to make any improvements authorized by the Act. Membership in the District is comprised of businesses within the A neighborhood.

As required by the City Council Resolution, owners of businesses within the A area are subject to a special assessment, as authorized under the Act. Failure by any business entity to pay the assessment is enforced by the City through their lien and collection procedures. The City Council Resolution sets forth the method by which assessments will be calculated, the maximum amount that may be levied, and the method by which assessments will be paid and collected by the District. These assessments must be used to provide such services to the District as regulation of traffic, oversight of public safety, and provision of maintenance services including street cleaning and lighting, as well as for security services. Street lights and other

improvements purchased by the District must meet City standards. The Act also allows use of assessment funds for District public relations programs and group advertising. The Act requires the District to provide annual audits and reports to the City government.

The Act and the City Council Resolution require appointment of a specified number of directors, representing the member businesses within the District area, and specified positions in the municipal government. All appointments of directors must be approved by City. The District's Articles of Incorporation and By-laws provide that all actions and decisions by the District are subject to the requirements of the Act and Resolution, as well as the approval of the City Council.

The Act requires that, upon sunset or dissolution, all assets and any property of the Corporation pass to City. Although the Act and City Council Resolution provide for a five-year sunset provision for the District, the Act permits extension of the District's existence by City through reenactment of the Resolution after review of the District's performance.

The District has entered into a Memorandum of Understanding with City for assistance in the provision of services to the District by various City departments, including Public Safety, Parking, Water and Sewer, Finance, and the Mayor's Office. The agreement insures that the various City Departments will provide the District with any personnel, equipment, or assistance needed to carry out the District's functions of providing needed maintenance, cleaning, and security services to the neighborhood. Any equipment, such as trash cans or street lights, purchased by the District with assessment funds becomes the property of City.

LAW AND ANALYSIS

Generally, if income is earned by an enterprise that is an integral part of a state or political subdivision of a state, that income is not taxable in the absence of specific statutory authorization to tax that income. See section 511(a)(2)(B)*;* Rev. Rul. 87-2, 1987-1 C.B. 18; Rev. Rul 71-131, 1971-1 C.B. 28; Rev. Rul. 71- 132, 1971-1 C.B. 29.

In Maryland Savings-Share Insurance Corp. v. United States*,* 308 F. Supp. 761, 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. Under MSSIC's charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Only three of eleven directors were selected by state officials. The district court rejected MSSIC's claim of intergovernmental tax immunity because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Thus, the imposition of an income tax on MSSIC would not burden the State of Maryland. Although the Supreme Court reversed the lower court on other grounds, it agreed with the lower court's analysis of the instrumentality and section 115 issues.

In State of Michigan and Michigan Education Trust v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992), the court held that the investment income of the Michigan Education Trust (MET) was not subject to current taxation under section 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). Moreover, the court's reliance on the factors listed in Rev. Rul. 57-128, 1957-1 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from a state. The factors in the revenue ruling do not determine whether an enterprise is considered to be a separate entity or an integral part of a state.

Nevertheless, in determining whether an enterprise is an integral part of a state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise.

Section 301.7701-1 et. seq. of the Procedure and Administration Regulations, the so-called "check-the-box" regulations, supports the position that an entity that is separate from a state or political subdivision may still be an integral part of that state or political subdivision. Section 301.7701-1(a)(3) provides, in part, that:

> An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.

Section 301.7701-2(a) provides:

> For purposes of this section and section 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under section 301.7701-3) that is not properly classified as a trust under section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-2(b) provides, in part:

> For federal tax purposes, the term corporation means --
>
> (1) A business entity organized under a Federal or State statute, or under

> a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
>
> (2) An association (as determined under section 301.7701-3);
>
> * * *
>
> (6) A business entity wholly owned by a State or any political subdivision thereof.

Thus, the check-the-box regulations indicate that even though the District is incorporated as a separate entity from City, it nevertheless may be treated as an integral part of City if it so qualifies.

The District was formed and is operated pursuant to the Act and City Council Resolution, which set forth and control the District's funding mechanism. Use of assessment funds is overseen by City through annual audits, budgets and reports. All property purchased by the District with assessment funds becomes the property of City. Further, all assets of the District pass to City in the event that the District sunsets or is dissolved. These factors demonstrate City's significant financial commitment to the District.

The facts also indicate that City, pursuant to the Act, exerts substantial control over the District, which was formed to augment certain City functions. The City Council Resolution specifies who may be selected for the District's board of directors and requires City Council approval of individuals selected to serve on the board. The Act and Resolution both set forth in detail how assessments must be calculated and what types of services may be purchased with assessment funding. Further, the City Council may enact ordinances that change the composition of the District's board of directors or change the maximum assessment level permitted. Enforcement of assessment collections are undertaken by City through its lien and collection functions. All improvements, which vest with City, must meet municipal standards and must be approved by the City Council. Various services provided by the District, such as street cleaning and sanitation, are coordinated through the appropriate City departments to avoid duplicate municipal services.

Because City has demonstrated its financial commitment and control over all aspects of the District and the services it provides, we conclude that the District is an integral part of City.

Because we have determined that the District is an integral part of City, we need not address whether its income is excludible from gross income under section 115(1).

CONCLUSION

The District is an integral part of City.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

Although the District is not required to file federal income tax returns, a copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is 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 submissions, the material is subject to verification on examination.

Sincerely,
Elizabeth Purcell
Chief, Exempt Organizations Branch 2
Office of District Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:
Copy for section 6110 purposes
cc: