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May 01, 2025

Legend

Taxpayer =

System =

University =

Hospital =

Center =

Employer =

State =

State 2 =

Act =

Act 2 =

Fund =

Dear :

This letter responds to a letter from your authorized representative, dated October 17, 2024, and subsequent documentation dated February 4, 2025 and March 25, 2025, requesting a ruling that Taxpayer's income is excludable from gross income under section 115(1) of the Internal Revenue Code (Code). Taxpayer represents the facts as follows.

FACTS

System is an integral part of State. State established System under Act. System's mission is to provide patient care in specialized services not widely available elsewhere,

and to provide care to medically indigent citizens of State. Act provides that the provision of health care services is an essential governmental function that protects and promotes the health and welfare of the citizens of State. Act also provides that the education of medical and health science professionals and the performance of medical and related research are essential to promote this essential governmental function. Act permits System to provide self-insurance and create a self-insurance entity to support its essential governmental function.

University is a state university located in State. Center is a University campus. Hospital is a teaching hospital for Center.

System and University formed Employer to provide System with an integrated faculty practice plan and clinical enterprise. Employer's principal activities are providing clinical services to Hospital's patients and supporting University's educational, research, and public service missions. The physicians who constitute the medical staff of System and System's subsidiaries are employees of Employer. Employer pays salaries to the physicians for their provision of medical care to Hospital's patients. Employer has a ruling that concludes its income is excludable from gross income under section 115(1) of the Code.

Taxpayer is a nonprofit mutual benefit corporation. System formed Taxpayer under the laws of State 2 to reduce System's costs of providing health care services to System's subsidiaries in order to protect System's financial integrity. Taxpayer provides captive insurance and risk-mitigation services solely to Taxpayer's members. Taxpayer provides its members with general liability insurance, primary medical professional liability insurance, and employee benefit liability insurance. All members of Taxpayer are required to pay annual premiums to Taxpayer, calculated at fair market value for the insurance coverage Taxpayer provides. Taxpayer's organizational documents provide that Taxpayer is intended to have the status of an organization whose income is excludable from gross income pursuant to section 115(1) of the Code, and that its authority and activities are limited accordingly. Taxpayer's organizational documents forbid Taxpayer from taking any action that would cause its income to be includible in gross income.

Taxpayer's membership consists of two classes, Class A and Class B. All members are insureds of Taxpayer, and every insured is a member of Taxpayer.

System is Taxpayer's sole Class A member. System has the exclusive right to receive distributions from Taxpayer, so long as System continues to be an integral part of State, or a political subdivision thereof.

Employer is currently Taxpayer's sole Class B member. Taxpayer's organizational documents allow additional organizations to become Class B members. Taxpayer's organizational documents require that Class B members be entities (i) that constitute an integral part of State, or a political subdivision of State; (ii) whose income is wholly

excludable from gross income under section 115 of the Code; or (iii) whose income is exempt from taxation under section 501(a) of the Code by virtue of being describe in section 501(c)(3) of the Code. Any Class B member admitted by virtue of being described in section 501(c)(3) of the Code must be either a governmental unit or an affiliate of a governmental unit, as described in Rev. Proc. 95-48. Class B members must be either wholly owned subsidiaries of System or wholly owned subsidiaries of such wholly owned subsidiaries of System. System, therefore, must be the direct or ultimate parent of, and wholly control, each Class B member. Class B members have no right to vote as members of Taxpayer. Class B members are not entitled to receive dividends or distributions from Taxpayer.

System must approve any Class B members of Taxpayer. System must appoint and remove the directors of all Class B members. System has the power to approve expenses and budgets and authorize debt of all Class B members. The assets of all Class B members must be distributed to System, or a similarly organized entity approved by System if such Class B member dissolves.

Taxpayer represents that Act 2, a State law, mandates that physicians employed by Employer be insured. Taxpayer further represents that Act 2 requires State, acting through University, Center, and Employer, to provide and pay for such insurance on behalf of Employer's employed physicians. Currently, System purchases such insurance from third-party insurance providers to comply with the requirements of Act 2. System created Taxpayer to provide captive insurance services to System and entities controlled by System in place of such third-party insurance providers.

Act 2 requires certain healthcare providers in State to maintain minimum professional liability coverage from a State-approved carrier. Act 2 also creates Fund to provide professional liability coverage for claims that exceed the required minimum coverage. In addition to purchasing minimum professional liability coverage, health care providers in State are required by Act 2 to pay an annual premium surcharge to the State-approved carrier, which the carrier then pays into Fund. The board of governors of Fund may issue a certificate of self-insurance to certain healthcare providers if the board of governors is satisfied that the healthcare provider possesses and will continue to possess the ability to pay any judgment for which liability exists equal to the amount of basic coverage required of a healthcare provider obtained against such applicant. Self-insurers are not required under Act 2 to maintain minimum coverage with a carrier but are still required to pay the surcharge to Fund. Act 2 deems Employer and its full-time physician faculty to be a self-insurer for the purposes of Act 2, and mandates that Employer must pay the annual surcharge on behalf of its employed physicians.

Other than the initial funding of Taxpayer by Taxpayer's members, Taxpayer's income is derived solely from premiums paid by its members in exchange for insurance coverage, as well as income generated by Taxpayer's investments. Taxpayer's income is used to fund its administrative expenses and cover the losses of its members under Taxpayer's insurance programs. Administrative expenses include payments to third-party service

providers for professional services, including accounting, policy documentation, claims management and administration, and compliance. All payments to outside service providers must be at arm's length and for fair market value.

Taxpayer's organizational documents state that no private person or entity can receive any net earnings from Taxpayer's operations, except as reasonable compensation for services rendered to or on behalf of Taxpayer.

Upon dissolution, Taxpayer must distribute its remaining assets to System, so long as System constitutes an integral part of State or a political subdivision thereof. If System fails to constitute an integral part of State or a political subdivision thereof, remaining assets must be distributed to State, a political subdivision of State, or an entity whose income is excludable from gross income under section 115(1) of the Code.

LAW

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 any political subdivision thereof.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that income generated by an investment fund that is established by a state to hold revenues in excess of the amounts needed to meet current expenses is excludable from gross income under section 115(1) of the Code, because such investment constitutes an essential governmental function. The ruling states that the statutory exclusion is intended to extend 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 either a state or political subdivision of a state. The ruling explains that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and that are within the ambit of a sovereign to conduct.

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 employee negligence, workers' compensation statutes, and employee health is excludable from gross income under section 115(1) of the Code 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.

ANALYSIS

State created System to provide patient care in specialized services not widely available elsewhere, and to provide care to medically indigent citizens of State. System created Taxpayer to serve as a replacement for commercial insurance carriers and to allow Taxpayer's members to pool their resources and to procure insurance services on a more cost-effective basis. By reducing the costs to System in obtaining insurance for System and entities wholly owned and controlled by System, Taxpayer performs an essential governmental function. See Rev. Rul. 90-74.

Taxpayer's income accrues to State or a political subdivision of State. Private interests benefit only incidentally. Any benefit to employees of Taxpayer's members is incidental to the public benefit. See Rev. Rul. 90-74. In no event, including upon dissolution, will Taxpayer's assets be distributed to any entity that is not State, a political subdivision of State, or another entity the income of which is excludable from its gross income by application of section 115(1) of the Code.

RULING

Based on the information and representations submitted on behalf of Taxpayer, we conclude that, because Taxpayer's income is derived from the performance of an essential governmental function, and because Taxpayer's income accrues to State or a political subdivision of State, Taxpayer's income is excludable from gross income pursuant to section 115(1) of the Code.

The ruling contained in this letter is based upon information and representations submitted by 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 a ruling, it is subject to verification on examination.

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 Taxpayer. 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 Taxpayer's authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by

attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Kenneth M. Griffin
Chief
Exempt Organizations Branch 3
(Employee Benefits, Exempt Organizations,
and Employment Taxes)

cc: