OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
April 9, 1999

CC:DOM:FS:FI&P
TL-N-1292-95
UILC: 115.02-00

Number: **199928011**
Release Date: 7/16/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS:FI&P

SUBJECT:

This Field Service Advice responds to your memorandum dated December 31, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

State =
Fund =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =
Year 9 =
Date 1 =

Date 2	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=

ISSUES:

Whether an entity created by a state to provide workers' compensation insurance to employers is exempt from Federal income tax as an integral part of the state, a political subdivision of the state, or because it meets the requirements of Internal Revenue Code § 115.

CONCLUSION:

Based on the information submitted, the entity's income is not exempt from Federal income tax as an integral part of the state or as a political subdivision of the state, nor does it meet the requirements of Internal Revenue Code § 115. The facts do not support a finding that the entity is an integral part of the state either through the state's control over the entity or the state's financial commitment to the entity. Further, there is no indication that the entity possesses any of the sovereign powers necessary to a finding that it is a political subdivision of the state. Finally, section 115 is inapplicable because the income from the entity accrues to private parties.

FACTS:

The facts, as stated below, are based solely on the information submitted and the representations in your memorandum.

State statute requires that all employers provide workers' compensation coverage for their employees. State created the Fund in Year 1 for the stated purpose of guaranteeing the availability of workers' compensation insurance at reasonable rates.

Establishment of Fund

The operation and organization of the Fund are governed primarily by provisions of State's Insurance Code. The Fund was initially formed as a public revolving fund consisting of appropriations approved by State Legislature, all insurance premiums received and all investment properties and net earnings therefrom. In Year 1, the Fund received an appropriation of $a from the State Legislature for initial working capital. In Year 2, the original appropriation of $a, plus interest, was returned to State. The Insurance Code provides that the Fund shall be fairly competitive with other insurers, and it is the intent of State legislature that the Fund shall ultimately be neither more nor less than self-supporting.

In Year 3, pursuant to the State Legislature's mandate that the Fund provide coverage, the Fund received a $b loan from a State revolving fund. The loan was repaid with interest in Year 4.

In Year 5, the legislature reorganized the Fund into a public enterprise fund in order to increase its autonomy and to accrue significant cost savings. Pursuant to this reorganization, the Fund was granted the authority to deposit and maintain its funds in financial institutions authorized by law to receive deposits of public moneys and to invest its funds, subject only to the restrictions applicable to private insurers. The Fund may also, with the approval of the State Treasurer, establish an account or fund in the State Treasury in the name of the Fund, but moneys deposited with the State treasurer are not state moneys within the intent of State statute. Prior to the Year 5 reorganization, the Fund's moneys were administered and maintained by the State Treasurer.

In addition, the Fund was granted greater freedom in conducting its affairs by exempting it, in most instances, from the provisions of the State Government Code applicable to state agencies. This action was purportedly for the purpose of enabling the Fund to become more competitive with other worker's compensation insurers. As a result of the legislative changes, the Fund generally transacts workers' compensation insurance to the same extent as any other insurer.

Operation of the Fund

Under State law, the Fund is governed by a board of directors vested with full power and authority as the governing body of a private insurance carrier. The board of directors is composed of five members appointed by the Governor, one of whom shall be from organized labor. In order to qualify for membership, the board members, other than the member from organized labor, must be policyholders or

employees of a policyholder in the Fund for one year prior to appointment and must continue in such status while a member. The Governor of State shall appoint the chairperson who shall serve at the pleasure of the Governor. State's Director of Industrial Relations shall be an ex officio, nonvoting sixth member of the board, and shall not be counted as a member of the board for quorum purposes. Prior to Date 1, the Director of Industrial Relations acted as chairman of the Fund's board of directors. However, a Year 6 statute granted the Director of Industrial Relations the power to impose fines and penalties on all workers' compensation providers, including the Fund. The resulting conflict of interest necessitated the board's reorganization.

The board of directors is authorized by statute to appoint and fix the salary of a manager for the Fund. The duties of the manager are to manage and conduct the business and affairs of the Fund under the general direction of, and subject to the approval of, the board of directors. The manager of the Fund has full authority to run the daily operations of the Fund, including the authority to enter into contracts of workers' compensation insurance, sell annuities covering compensation benefits and decline to insure any risk which is beyond the safe carrying of the Fund. The manager is required to report quarterly to the Governor on the business of the Fund.

Pursuant to statute, the Fund may declare policyholder dividends provided there exists a surplus of assets. Such cash dividend or credit is to be in an amount which the board of directors in its discretion considers to be the employer's proportion of divisible surplus. In Years 7, 8 and 9, the Fund paid or credited to private employer policyholders dividends in the amounts of $c, $d and $e, respectively.

Employees of the Fund are subject to State's civil service system. State delegates certain personnel functions to the Fund, including approving appointments for officer positions and the hiring and firing of employees. Salaries for the Fund's employees are set by State's Office of Personnel Administration. The Fund's employees receive the same benefits afforded to employees of State agencies. Salaries and benefits of the Fund's employees are paid from revenues generated from the Fund's insurance and investment income.

The State Department of Insurance regulates all insurance business in the State, including the Fund. Prior to Year 9, State mandated the minimum rates to be charged by the Fund for workers' compensation insurance. Due to an adverse effect on businesses, the minimum rate law was repealed and an open rating system was implemented. The Department of Insurance continues to establish

rates charged by the Fund; however, rates are fixed with consideration to the physical hazards of each industry, occupation or employment. Other insurers are permitted to calculate their rates subject to the approval of the Department of Insurance. Although the Fund acts as the insurer of last resort, premiums are commensurate with the calculated amount of risk involved, and it can deny coverage if an employer fails to meet minimum standards.

Under State statute, the Fund annually pays a tax computed on the same basis, at the same rates, and subject to the same deductions as those applicable to private insurers within the State. Thus, private insurers, including the Fund, pay gross premium taxes and property taxes, but not state income taxes.

State statute provides that all business and affairs of the Fund shall be conducted in the name of the Fund, not as part of a governmental body. State statute provides that State shall not be liable for any obligations of the Fund beyond its assets. The Fund may also sue and be sued in all actions arising out of any act or omission in connection with its business or affairs. The Fund is also not immune from punitive damages. State requires Fund to share in the cost of operating the state government. For Years 7, 8 and 9, the Fund's share of such costs was $f, $g and $h, respectively.

The Fund is the largest writer of workers' compensation insurance in State. The Fund provides workers' compensation insurance to more than half of all employers in State, including both public and private employers. The Fund also serves as a third-party administrator in the adjustment and disposition of claims for workers' compensation for any public employers electing to self-insure. The Fund has $i in assets. As of Date 2, Fund's capital and surplus were $j. State statute does not provide for distribution of Fund's assets upon dissolution.

LAW AND ANALYSIS

1. Integral Part of a State

Income earned by a state, an integral part of a state or 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.

Whether an enterprise is an integral part of a state depends upon all the facts and circumstances, including the state's degree of control over the enterprise and the extent of the state's financial commitment to the enterprise. In Maryland

Savings-Share Insurance Corp. ("MSSIC") v. United States, 308 F.Supp. 761 (D.Md.), rev'd on other grounds, 400 U.S. 4 (1970), 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 were not pledged for MSSIC's obligations. Only three of the eleven directors were selected by state officials. The district court rejected MSSIC's claims of intergovernmental tax immunity and exemption under section 115 of the Code, 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 district court was reversed on other grounds, the Supreme Court agreed with the lower court's analysis of the tax exemption issues. 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 section 115." MSSIC, 400 U.S. at 7, n. 2.

In Rev.Rul. 87-2, the Service addressed the question of whether an enterprise is an integral part of a state and therefore entitled to exemption from federal taxation. In that ruling, attorneys were required to deposit clients' funds of nominal amounts into a pooled interest bearing trust account fund. The ruling held that interest paid on the accounts, which was disbursed for public purposes, was not subject to federal income tax. The state Supreme Court's creation and administration of the trust account fund and the court's ability to select and remove the fund's governing body, to control the fund's investments and expenditures, to monitor the fund's daily operation, and to abolish the fund indicated that the fund was not an independent entity but rather was an integral part of the state.

While the facts in the present case indicate that State maintains a certain degree of control over the administration of Fund, it is unlikely that such control rises to the level necessary to establish that Fund is exempt from taxation as an integral part of State. Where State may have arguably exercised greater control in the past, legislative changes have reduced the State’s degree of control over the Fund, purportedly with the objective of increasing its competitiveness with private insurers. For example, although it is a creation of the State Legislature, since Date 1, the Fund has been controlled by a board of directors, the majority of which are private policyholders. And though the Fund's employees are subject to State civil service requirements, the manager of Fund is appointed by and conducts the business and affairs of the Fund under the direction and subject to the approval of the privately dominated board. In general, the Fund transacts business in workers’ compensation insurance to the same extent as any private insurer.

Further, the Fund is generally not subject to the provisions of the Government Code applicable to state agencies and apparently operates independently of the State Treasurer. The board of directors may invest funds in excess of reserve requirements in the same manner as private insurance carriers. The Fund is authorized to deposit surplus cash in financial institutions authorized by law to receive deposits of public moneys. The board of directors may also establish an account or fund in the State Treasury in the name of the Fund; however, moneys deposited with the State Treasurer are not State moneys within the intent of State statute.

While State's Department of Insurance regulates the rates charged by the Fund, the minimum rate law was repealed and an open rating system was implemented calculating premiums at a level commensurate with the amount of risk present in each industry. Accordingly, the facts suggest that the Fund's premiums are set at rates that are competitive with private insurers. Moreover, despite the Fund's role as the insurer of last resort, the manager of the Fund may decline to insure any risk which is beyond the safe carrying of the Fund.

Most significant is State's apparent lack of financial commitment to the Fund. The facts indicate that the Fund's primary sources of operating revenue are premiums and investment earnings. In addition, State statute specifically provides that the Fund shall be self-supporting. Although State provided the initial contribution in Year 1 and an additional amount in Year 3, such contributions were limited in both amount and duration. The initial contribution was repaid with interest in Year 2. The contribution received in Year 3 was characterized as a loan and was also repaid with interest. Nor can it be argued that the Fund receives a financial commitment from the State in the form of foregone taxes. The facts indicate that State statute insures that Fund pays the same tax as private insurers.

In addition, the Fund's income benefits private parties rather than accruing to State. The board of directors may declare policyholder dividends if surplus funds exist. Such cash dividend or credit is to be in an amount which the board of directors in its discretion considers to be the employer's proportion of divisible surplus. As discussed, premiums were paid in Years 7, 8 and 9 in the amounts of $c, $d and $e, respectively. While the Fund is responsible for a portion of State's operating costs, such amounts are minimal when compared to the recent dividends that have been paid to the private policyholders.

Finally, the State is not responsible for any operational deficit of the Fund or for any shortfall between the Funds' assets and claimants' actual losses. There is no provision for the termination of the Fund or the distribution of its assets.

Accordingly, despite the State's involvement in certain aspects of the Fund, such as the regulation of insurance premiums, the facts do not support a finding that the Fund is an integral part of the State. The mere fact that an entity is regulated does not result in tax exempt status. Income from the Fund benefits private parties, and the State lacks the level of control or the financial commitment necessary to treat the Fund as an integral part of the state.

2. Political Subdivision

The term “political subdivision” is not defined in the Internal Revenue Code. Treas. Reg. § 1.103-1(b), however, provides that the term “political subdivision” denotes any division of any state or local governmental unit that is a municipal corporation, or which has been delegated the right to exercise a portion of the sovereign power of the governmental unit.

The three generally acknowledged sovereign powers are the police power, the power to tax, and the power of eminent domain. Estate of Shamberg, 3 T.C. 131, 143, aff’d, 144 F.2d 998 (2d Cir. 1944), cert. denied 323 U.S. 79 (1945). While it is not necessary that all three of these powers be delegated to treat an entity as a political subdivision, possession of only an insubstantial amount of any or all sovereign powers is not sufficient. An entity must possess and exercise a significant amount of sovereign powers. See Rev. Rul. 77-164, 1977-1 C.B. 20. All of the facts and circumstances must be considered, including the public purposes of the entity and the extent of control by a governmental unit. Id.

From the facts provided, there is no indication that the Fund possessed any of the traditional sovereign powers. The police power of a state encompasses regulations designed to promote public health or public safety. While the Fund’s purpose of providing workers’ compensation insurance arguably falls within the ambit of promoting public health or safety, Fund’s limited authority with respect to this power is tenuous at best and has been delegated to private organizations as well. Further, engaging in an activity is distinguishable from regulating an activity or exercising the power of government. See Philadelphia National Bank v. United States, 666 F.2d 834 (3d Cir. 1981), cert. denied, 457 U.S. 1105 (1982). Therefore, based on the information provided, the Fund’s income would not be exempt from tax as a political subdivision of State.

3. Section 115

Section 115(1) of the Code provides that income is excluded from taxation if it is derived from the exercise of any essential governmental function and accrues

to a state or any political subdivision. The accrual test is satisfied if, upon dissolution, assets of the entity are distributed to the state. Rev.Rul. 90-74, 1990-2 C.B. 34

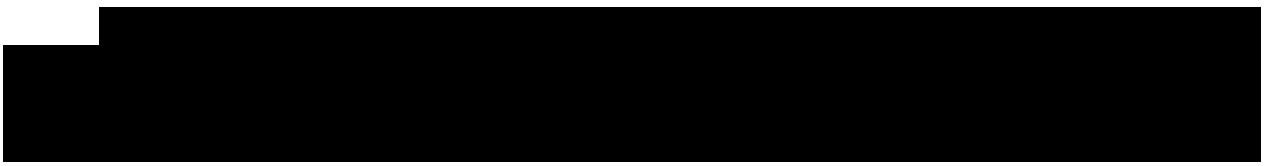
In Rev. Rul. 77-261, 1977-2 C.B. 45, a state and the participating political subdivisions had an unrestricted right to receive a proportionate share of the income earned by a joint investment fund. The ruling states that section 115(1) does not require that the income in question accrue only to a state or a single political subdivision and concludes that the income accrues under section 115(1) even though more than one governmental entity participated in the fund.

Rev.Rul. 90-74 holds that the income of an organization formed, operated and funded by political subdivisions to pool their casualty risks, or other risks arising from their obligations concerning public liability, workers' compensation, or employees' health is excluded from gross income under section 115(1) if private interests do not participate in the organization or benefit more than incidentally from the organization. Rev.Rul. 90-74 illustrates that section 115 does not apply to an entity's income if there is more than an incidental private benefit connected with the income.

From the information submitted, Fund's income accrues primarily to the private policyholders. While State also receives a minimal financial benefit from the Fund's operations, the benefit received by private parties is more than incidental. Moreover, State statute does not provide for the termination of the Fund or the distribution of its assets. For the reasons discussed, the facts do not warrant excluding the income of the Fund under section 115.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As discussed, a determination that an entity is not an integral part of a state, a political subdivision of a state or exempt from taxation under section 115 is based on the facts and circumstances. While it is our opinion that the facts presented support a determination that the Fund's income is not exempt from tax under any of the theories discussed, as with any factual determination, there are appreciable hazards to litigation.



[redacted]

Furthermore, the creation of the Fund by State, the appointment of board members by the Governor, State's regulation of premiums, and the fact that the Fund's employees are subject to civil service requirements are several additional points to consider when assessing the hazards of litigation. Although it is our opinion that the available facts do not support a determination that the Fund is state-controlled, there are facts present from which a court may reach a contrary result.

With respect to the financial commitment element, there is currently no precise test as to what constitutes an acceptable financial commitment for purposes of the integral part doctrine. In the present case, there appears to be a complete lack of financial commitment as the Fund is self-supporting, State is not responsible for any operational deficit of the Fund and any contributions to the Fund were repaid with interest. Due to the dearth of reported cases in this area, however, there is a slight risk that a court may conclude that the initial contribution and/or the contribution in 1976 constitutes a financial commitment by State.

In addition to the above litigation hazards, we also recommend that you consider the provisions of recently enacted section 501(c)(27)(B) when determining how to proceed with this matter.

Specifically, section 501(c)(27)(B), amended by the Taxpayer Relief Act of 1997, provides an exemption for any organization (including a mutual insurance company) if - -

> (i) such organization is created by State law and is organized and operated under State law exclusively to - -
>
> > (I) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if such insurance is not purchased by an employer, and
> >
> > (II) provide related coverage which is incidental to workmen's compensation insurance.

> (ii) such organization must provide workmen's compensation insurance to any employer in the State (for employees in the State or temporarily assigned out-of-State) which seeks such insurance and meets other reasonable requirements relating thereto,
>
> (iii) (I) the State makes a financial commitment with respect to such organization either by extending the full faith and credit of the State to the initial debt of such organization or by providing the initial operating capital of such organization, and (II) in the case of periods after the date of enactment of this subparagraph, the assets of such organization revert to the State upon dissolution or State law does not permit the dissolution of such organization, and
>
> (iv) the majority of the board of directors or oversight body of such organization are appointed by the chief executive officer or other executive branch official of the State, by the State legislature, or by both.

We express no opinion as to whether the Fund qualifies for exempt status under section 501(c)(27)(B). The cited provision is effective only for tax years beginning after December 31, 1997, and is not applicable to the Fund's tax years under consideration. Further, to benefit from the provisions of section 501(c)(27)(B), the Fund must apply for recognition of exempt status under the procedures enumerated in Rev. Proc. 99-4, 1999-1 I.R.B. 115.

[redacted].

A determination as to whether the Fund's conduct in prior years was egregious must be based on the facts and circumstances. Generally, however, such a finding would be limited to those instances where the Service can show that there were intentional and continuing violations of the provisions of the Code. For example, if the Fund continued to treat its income as tax-exempt, despite a determination by the Service that such income was taxable, its conduct may be sufficiently egregious to preclude eligibility for a closing agreement. In addition, attempts to mislead the Service as to the nature of the Fund's income, such as

through false statements regarding the Fund's operations or the extent of State's control or financial commitment, may also constitute egregious behavior.

Egregious conduct, as contemplated above, is unlikely to be found except in rare circumstances. Evidence establishing false or misleading statements would be difficult to obtain and would consist primarily of witness testimony or internal correspondence. In the present case, no information has been presented that would suggest egregious conduct on the part of the Fund.

[redacted]

Please call if you have any further questions.

By: _____
CAROL P. NACHMAN
Special Counsel
Financial Institutions and Products

cc: