

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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August 16, 2004

**LEGEND**

Company =

Parent =

State =

Agency =

Pool =

Dear :

This is in reply to a letter dated March 5, 2004, and subsequent submissions, requesting a ruling that the income of Company is excluded from gross income under § 115(1) of the Internal Revenue Code.

**FACTS**

Parent is an association of cities whose members are all city governments in State. Parent provides its members with legislative, financial, insurance and legal assistance. Members are assisted in obtaining insurance by Agency, a wholly owned subsidiary of Parent. Agency acts as an insurance agent and broker for cities and other government entities in State. It attempts to obtain insurance services at a lower cost than could be obtained commercially by city governments. In addition, Pool, an

interlocal agency created by various city governments in State, operates a self-insurance pool in which cities and certain other government entities may participate. Parent, Agency and Pool have all received a ruling from the Service that their income is excluded from gross income under § 115.

Company is a state chartered stock corporation. Like Agency, Company is a wholly owned subsidiary of Parent. It was formed to allow cities and other government entities that participate in Pool's insurance risk pool the option of paying their premium over a period of up to nine months as an alternative to making a single payment early in the fiscal year. In no case may an organization other than a state, a political subdivision of a state, or an entity the income of which is excluded from gross income under § 115 participate in Company's premium financing program. Parent has no subsidiaries other than Company and Agency.

Company is governed by a board of three directors. Company's directors are elected city officials who are selected by Parent's board. Company derives its income from interest paid by the cities and other government entities that chose to finance their insurance premiums. The income is used to cover administration costs and interest charges for Company's line of credit. Any surplus is transferred to Parent. Company's articles of incorporation provide that its assets shall not inure to the benefit of any private person or entity. Parent represents that neither it nor its two subsidiaries, Company and Agency, have entered into a profit or revenue sharing agreement with any person or entity. Upon the termination of Company, Company's assets will be distributed to Parent. Upon the dissolution of Parent, Parent's assets will be distributed to the members of Parent.

#### LAW AND ANALYSIS

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 government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was 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 a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling points out 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 which are within the ambit of a sovereign to properly conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is

subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Company was established to help the member cities of Parent and certain other entities to finance their insurance premiums. By helping city governments and other government entities acquire necessary insurance coverage at a reasonable cost and by helping the cities to better manage cash flows Company performs an essential governmental function.

Company's income will be used to pay administrative costs and interest charges on Company's line of credit. Any surplus is transferred to Parent. No part of the income or earnings may inure to the benefit of any private interest. Upon dissolution, Company's assets will be distributed to Parent, an organization the income of which is excluded from gross income under § 115. Upon the dissolution of Parent, Parent's assets will be distributed to the members of Parent, all of whom are political subdivisions of State. The income of Company will only accrue to a state, a political subdivision of a state or an entity the income of which is excluded from gross income under § 115(1). Accordingly, the income of Company is excludable from gross income under § 115 of the Code.

This ruling presumes that 100% of the ownership of Company will be held by Parent. If Company issues additional stock, it must be held by a state, a political subdivision of state or an organization the income of which is excluded from gross income under § 115. In addition, only a state, a political subdivision of a state or an organization the income of which is excluded from gross income under § 115 may receive a transfer of any portion of the ownership of Company. The ruling further presumes that Parent, Agency and Pool will all continue to qualify as organizations the income of which is excluded from gross income under § 115.

Except as specifically provided otherwise, no opinion is expressed on the federal tax consequences of any particular transaction.

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

Sincerely,

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Barbara E. Beckman  
Assistant Chief, Branch 2  
Exempt Organizations  
Division Counsel/Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosures:

Copy of this letter  
Copy for § 6110 purposes

cc: