

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date:

January 06, 2004

LEGEND

Association =

State =

Statute A =

Dear :

This is in reply to a letter dated July 7, 2003, requesting a ruling that the income of Association is excluded from gross income under § 115(1) of the Internal Revenue Code.

FACTS

Association is an unincorporated association established pursuant to State Statute A to establish a group self-insurance pool for political subdivisions of State. Most of the members are school districts. The purpose of each of the members is related to public education.

Association is governed by a board of fifteen directors. Thirteen of the directors are a duly elected representative or employee of a member of Association. No two directors shall be a representative or employee of the same member. These directors are elected by majority vote of the board then in office. One director is appointed by the General Agent/Marketing Director of Association and one director is appointed by the Administrator /Manager of Association. The General Agent/Marketing Director and the Administrator/Manager are either individuals employed by Association or employees of a

corporation hired to perform services for Association. They both serve for a term established by the board of directors pursuant to a contract agreed upon by the board of directors.

The plan provides property, liability, fleet and other coverage to its members. Coverage programs are developed specifically for each member's risk management needs. The amount of premiums which each member pays for its coverage is determined through the application of uniform underwriting criteria addressing the members' exposure to loss. Members are responsible for their deductible amounts which vary from member to member. To date, Association has reinsured 100% of its member's risk with commercial reinsurers rather than utilize a risk pool of member funds to pay for member losses. The reinsurance premiums ceded to the reinsurers have historically been equal to the amount of premiums received by Association from its members less administrative fees and an annual membership fee. The annual membership fee is intended to cover the administrative expenses of Association for the year. These expenses consist principally of professional fees and directors' travel and meeting expenses. Association is the primary obligor with respect to the payment of covered claims and losses incurred by its members. These payments, however, are ultimately funded by proceeds received from the reinsurers.

Association's income comes from premiums and annual membership fees and investment income from the short-term investment of membership fees and premiums for the period between receipt of the funds and the time at which such funds are required to be paid as premiums to the reinsurers. The investment income is used to help fund Association's operating expenses, reducing the amount of the annual membership fee charged to the members. In the event Association is terminated, all assets remaining after payment of the debts and liabilities of Association will be distributed to the members of Association. Association represents that its charter documents will be amended to provide that in no case will a member be other than a state, a political subdivision of a state, or an organization the income of which is excluded from gross income under § 115 of the Code.

LAW AND ANALYSIS

Section 115

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 utilities 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.

Association was created to provide insurance for its members against liabilities and risks arising from the conduct of governmental functions. By providing insurance coverage in a cost effective manner Association is helping its members to protect their financial integrity. The type of benefits provided by Association are similar to those described in Rev. Rul. 90-74. Association, like the organization described in Rev. Rul. 90-74, performs an essential governmental function within the meaning of § 115(1).

The income of Association accrues to its members, all of which are required to be political subdivisions or entities the income of which is excluded from gross income under § 115(1) of the Code. Private interests neither materially participate in the organization nor benefit more than incidentally from the organization. Upon dissolution, the assets of Association are distributed to its members. Accordingly, the income of Association is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of § 115(1). Provided that Association amends its charter documents as described above, we conclude that Association's income is excludable from gross income under § 115(1) of the Code.

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,

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: