

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

April 29, 1999

Number: **199930028**

Release Date: 7/30/1999

Legend:

Utility =

City =

State =

State Agency =

Date X =

Transfer Agreement =

Dear :

This ruling responds to your letter dated March 22, 1999, requesting a ruling that (1) the income of Utility is excludable from gross income under section 115(1) of the Internal Revenue Code, and (2) Utility is not required to file a Form 990 under section 6033.

FACTS

City is an incorporated political subdivision of State. Utility is a wholly-owned public utility company of City and is exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). City created Utility by ordinance adopted on Date X for the purpose of operating the municipal electric and natural gas utilities on behalf of City. These utility services are authorized and created pursuant to State statute.

Utility administers a contract that the City has with State Agency. The contract requires Utility to purchase from State Agency all of the electric power and energy required by Utility to provide utility services for the next twenty-five years. A

representative of Utility serves on the Board of Directors of State Agency. The Mayor of City nominates the representative, subject to the advice and consent of the City's council. State Agency was formed pursuant to State statute and is comprised of a group of State municipalities that each own or operate an electric utility. State Agency was organized to pool municipal resources to secure an adequate, reliable and economic supply of electric power to its members.

The utility services provided by Utility are available to all individuals within the service area authorized by State statute. Utility derives substantially all of its income from the resale of electric power and natural gas to end-user customers, including several medium-sized industrial customers. Utility may receive income in the future from transportation charges for delivering electric power and natural gas to customers' facilities. Additionally, Utility may contract in the future with City to operate City's sewage treatment plant.

The net income of Utility accrues to City through regular periodic payments in the amounts set forth in the Transfer Agreement between City and Utility. Utility's articles of incorporation provide that no part of its earnings shall inure to the benefit of, or be distributable to, its members, trustees, directors, officers, or other private persons, except that Utility shall be authorized to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of its activities as a public utility. In the event of Utility's dissolution or cessation of business, all its assets, after payment of debts and obligations, shall be distributed to City.

#### 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 section 115(1). The ruling indicates 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 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 section 115(1) of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Utility, a wholly owned public utility company of City, was organized and is operated for the specific charitable purpose of lessening the burdens of the government of City by providing electrical and natural gas utilities. The net income of Utility accrues to City, a political subdivision of State, through regular periodic payments. No part of Utility's earnings shall inure to the benefit of, or be distributable to, its members, trustees, directors, officers, or other private persons. Additionally, in the event of Utility's dissolution or cessation of business, all its assets, after payment of debts and obligations, shall be distributed to City.

Accordingly, the income of Utility will be derived from its activity as a public utility and will accrue to a political subdivision of State within the meaning of section 115(1). Therefore, we conclude that the income derived from Utility from its operation as a public utility will be excludable from gross income under section 115(1).

Section 6033 of the Code provides that every organization exempt from federal income taxation under section 501(a) must file an annual information return (Form 990). Section 1.6033-2(g)(1)(v) of the Income Tax Regulations states that annual returns required by section 6033 of the Code are not required to be filed by an organization exempt from taxation under section 501(a) of the Code that is a "state institution," the income of which is excludable from gross income under section 115(1). See also Rev. Proc. 95-48, 1995-2 C.B. 418.

We have determined that the income of Utility is excludable from gross income under section 115(1) of the Code. The Service has previously determined that Utility is an organization described under section 501(c)(3) and thus exempt from federal income tax under section 501(a). Accordingly, Utility is a state

institution within the meaning of section 1.6033-2(g)(1)(v) of the regulations and therefore is not required to file an annual return under that section. Section 1.6033-2(g)(1)(v) of the regulations, however, does not apply to exempt a taxpayer from filing returns reflecting unrelated business taxable income under section 511 of the Code.

#### CONCLUSIONS

We conclude that income derived by Utility is excludable from gross income for federal income tax purposes under section 115(1) of the Code. We further rule that since Utility has obtained a ruling that it is exempt from federal income tax under sections 501(a) and 501(c)(3), Utility will not have to file a Form 990 under provisions of section 1.6033-2(g)(1)(v) of the regulations. No opinion is expressed, however, regarding whether an annual return must be filed if Utility has unrelated business taxable income under section 511 of the Code.

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code.

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

In accordance with the provisions of a power of attorney currently on file, we are sending a copy of this ruling letter to your authorized representative.

Sincerely yours,

Assistant Chief Counsel  
(Financial Institutions & Products)

By: William E. Coppersmith  
William E. Coppersmith  
Chief, Branch 2

Enclosure:

Copy of this letter  
Copy for section 6110 purposes

