

Internal Revenue Service

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Washington, DC 20224

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Person To Contact:

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Date:

September 24, 2004

TY:

Legend

<u>A</u>	=
State	=
Department	
Commissioner	=
Statute	=
Code	=
<u>A Plan</u>	=
<u>a</u>	=
<u>b</u>	=
Date 1	=
Date 2	=

Dear :

This is in response to your letter dated October 2, 2003, as supplemented by correspondence providing additional information, requesting the following ruling:

Whether Taxpayer's income is exempted from federal income taxation by section 115 of the Internal Revenue Code.

FACTS AND REPRESENTATIONS

According to the information submitted, A was formed in Date 1 pursuant to State Statute and is a residual risk pool for State's residential property insurance market. Section 1(a) of Statute defines A as "a nonprofit association established pursuant to this Act to develop and administer a program to provide residential property insurance in

PLR-160213-03

designated underserved areas in this state. A's operations were initiated on Date 2 to address a crisis in availability of residential property insurance in the voluntary market due to rising policy losses primarily associated with a damage. A's stated purpose is to "deliver residential property insurance to citizens of this state in underserved areas, which shall be determined and designated by the commissioner by rule." Insurance is made available by A to applicants who, after diligent attempts, are unable to obtain insurance in the voluntary market as evidenced by two declinations from insurers licensed to write and actually writing insurance in State. Statute requires every insurer transacting residential property insurance business in State to participate in the writings, expenses and losses of A in the proportion that its net direct premiums written bear to the aggregate net premiums written by all insurers. A may contract with its member insurers, nonmember insurers, private non-insurers, or State insurance pools to service A's policies, or may service the policies itself. No entity, member or nonmember can be compelled to service some or all of A's policies. All policies shall be issued in the name of A.

Commissioner has designated all the counties of State as underserved areas for A Plan because it determined that residential property insurance is not reasonably available to a substantial number of owners of insurable property in these areas. A has authority to write policies throughout the State. A may be deactivated by the Commissioner.

A is administered by b Governing Committee pursuant to a Plan of Operation subject to the approval of the Commissioner who shall adopt the plan and any amendments by rule. The members of the Governing Committee are appointed by Commissioner. Five members represent the interests of insurers, four members are public members and two members are licensed local recording agents.¹ Commissioner or Commissioner's designated representative serves as an ex officio member. The Plan of Operation states that if a Governing Committee member representing the interest of an insurer vacates the position prior to the end of the term, then the insurer employing that member shall have the ability to appoint a replacement within 45 days to serve the remainder of the term. If the insurer fails to appoint a replacement, then Commissioner shall appoint a replacement to serve the remainder of the term. If any other Governing Committee member vacates a position prior to the end of the term, then Commissioner shall appoint a replacement to serve the remainder of the term. You state that proposed legislation will be enacted providing the Commissioner with the express power to remove a Governing Committee member at any time.

¹ According to the information provided, a proposed statutory change will change "local recording agent" to "general lines and property casualty agent". You represent that this change is not a substantive change, but simply conforms the statute to the terms currently used to describe such agents. Historically, Commissioner has appointed independent agents to represent this group.

PLR-160213-03

A's net income, if any, is reserved for use in pursuit of its purposes, or upon termination, transferred to the general fund of State treasury.² A's profits may not be distributed to insurers. According to the information provided, legislation will be proposed to add a sentence to A's enabling statute stating that "upon dissolution, all of the assets revert to this state's general revenue fund." A was empowered to issue startup assessments from all of its members based upon the members percentage of written residential property insurance premiums. Additionally the Governing Committee may levy interim assessments against member insurers to provide necessary operating funds. Losses and expenses in excess of premiums are met by proceeds of revenue bonds, or assessments against the member insurance companies. To date, no assessments against insurance companies have been made, nor has any action been taken with respect to the issuance of bonds.

Member insurance companies have the right to recover assessments, whether startup, interim or to cover a deficit, by surcharging premiums on property insurance policies in the voluntary market. A must comply with all reporting requirements of Commissioner as well as provide annual and quarterly financial reports regarding A's operations. Applicants and affected insurers have the right to appeal any decision of A directly to the Commissioner. Commissioner adopts rates, endorsements, policy forms and rating and rule manuals for A, and has free access to all of A's books and records.

Applicants and affected insurers have the right to appeal any decision of A to its staff or administrator. Each denial of insurance shall be accompanied by a statement to the applicant and the agent that the applicant or affected insurer has the right to appeal and how appeal can be made. Such appeal shall be made in writing thirty days after receipt of the notice of decision. The staff or the administrator shall render its decision within forty-five days of receipts and an applicant or affected insurer shall have the right to appeal this decision to the Commissioner whose decision shall be a final order and subject to judicial review as provided in State Insurance Code.

² Recent amendment of A's enabling Statute prohibits excess funds from being distributed to private parties. A's Plan of Operation was amended at a Board meeting in June 2004 to conform to the Statute. Prior to amendment, the Plan of Operation provided that funds in excess of that needed to carry out all incurred claims to maturity and to meet the expenses incurred in the writing and servicing of that business and to meet the expenses of A shall be added to the reserves of the A for future catastrophes, and possible fluctuations in existing claim reserves. Subject to Commissioner's approval, any funds in excess of the amounts so needed shall be distributed to A's members to reimburse each member for any and all costs, taxes and other expenses associated with participation in A using the same formulas as for assessments of A's members. The amendment of the Plan of Operation deleted this provision so that it conforms to Statute.

PLR-160213-03

A does not have express termination provisions, however its Plan of Operation does provide A the ability to conclude its affairs if A Plan is deactivated by Commissioner. The Plan of Operation also provides that A's Governing Committee may adopt a written program to decrease the utilization of A as a source of insurance. Depopulation plans may also be adopted to reduce the number of risks insured by A.

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 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 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 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 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

By providing residential property insurance for those unable to obtain it on the voluntary market, A is helping maintain its communities and prevent their deterioration and is performing an essential governmental function. This is also reflected by the fact that all residential property insurers transacting business in State are required to participate in A. Furthermore, it is represented that A's enabling statute will be amended to require distribution of funds to the state general fund upon dissolution. Only upon passage of such amendment by State legislature will A's income accrue to State for purposes of Section 115(1) of the Code. A's Plan of Operation has been amended to prohibit the distribution of some of A's funds to its members. Furthermore, private interests do not materially participate in the organization nor benefit more than incidentally. Accordingly,

PLR-160213-03

after the above referenced statutory amendments, A's income will be exempt from income taxation under section 115(1).

Conclusion

A's income is exempt from taxation under section 115(1) of the Code. This ruling is conditioned upon A's enabling statute being amended to include a dissolution clause providing that A's assets revert to the State's general revenue fund upon dissolution and provide Commissioner with the authority to remove any member of the Governing Committee at any time.

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 the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

Sincerely,

Robin Ehrenberg
Senior Attorney, Exempt Organizations
Branch 2
Office of Division Counsel/Associate Chief
Counsel
(Tax Exempt & Government Entities)

cc: