

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:

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Date: January 14, 2004

In Re:

**Legend**

State A =

Act B =

Department D =

Center X =

Year 1 =

Dear :

This letter responds to your October 6, 2003, private letter ruling request. You have requested a ruling as to whether Center X is an instrumentality of State A for the purposes of Internal Revenue Code (the Code) § 3121(b)(7)(F).

**Facts:**

In year 1, Center X was incorporated under the general nonprofit law of State A. Subsequently, the legislature of State A enacted Act B. Center X amended its bylaws to implement all of the provisions of Act B. Center X received a favorable determination letter from the Internal Revenue Service indicating that it is exempt from federal income taxes under Code § 501 as an organization described in Code § 501(c)(3).

Under Act B, Department D is required to contract with nonprofit corporations such as Center X to coordinate and deliver services to developmentally disabled people in a specific geographic area. Center X coordinates the provision of services in nine counties in state A. Currently in State A, there are 21 similar centers (the centers).

Center X coordinates community resources such as education, recreation, health and welfare. Further, Center X provides a wide array of services directly to the developmentally disabled within its region and funds health services that are not covered by other funding sources.

**Law:**

Code § 3101(a) imposes a tax on employees for Old Age, Survivors, and Disability Insurance (i.e., the social security tax) on the income of every individual received by such individual with respect to employment. Code § 3111(a) imposes the social security tax on employers, calculated as a percentage of wages with respect to employment. Subject to certain exceptions not applicable in this case, Code § 3121(b)(7)(F) provides that the definition of "employment" includes service in the employ of a state, or any political subdivision thereof, or of any instrumentality of the foregoing, by an individual who is not a member of a retirement system of such state. In Revenue Ruling 57-128, 1957-1 C.B. 311, the Internal Revenue Service set forth the following six factors to take into consideration in determining whether an organization is an instrumentality of a state or political subdivision for purposes of Code § 3121:

(1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) whether express or implied statutory or other authority is necessary or exists for the creation and/or use of the organization; and (6) the degree of financial autonomy and the source of its operating funds.

**Analysis:**

1. Governmental Purpose and Function.

Pursuant to Act B, the centers were created in order for State A to carry out many of its responsibilities for providing services and support for the developmentally disabled. Under Center X's bylaws, the express purpose of Center X is to carry out the provisions of Act B. Center X provides services such as recreation, health, rehabilitation, welfare and education for individuals with developmental disabilities. Many of the duties that Center X performs under a contract with Department D are duties that Department D or another State A agency would otherwise perform. For example, except for those judicially committed to a state hospital, no developmentally disabled person is admitted

to a state hospital without a referral from the appropriate center. Similarly, upon discharge, a developmentally disabled person is referred to the appropriate center. Accordingly, we conclude that Center X carries out a governmental purpose and performs a governmental function in the nine counties in which it operates.

2. Function Performed on Behalf of State.

As noted above, the centers are organized and operate under Act B to provide social welfare services to developmentally disabled individuals on behalf of State A. The centers were created to provide services that would otherwise be provided by Department D. Under Act B, Center X also has powers exercised concurrently with Department D, such as unannounced visits to service provider facilities. Additionally, Act B provides that under certain conditions and for a limited time Department D can directly operate Center X in order to avoid service disruption. Accordingly, we conclude that Center X performs its functions on behalf of Department D.

3. Private Interest versus Government Ownership.

Center X's articles of incorporation provide that Center X's purpose is exclusively to promote social welfare. Less than one percent of Center X's operating budget comes from funds other than those provided by Department D and State A. Under its contract with Department D, all the materials, supplies and property furnished by State A or purchased with funds received under the contract are the property of State A unless a specific exception applies. All unused contract funds revert back to Department D at the end of each fiscal year. In addition, all of Center X's bank accounts and investments are held jointly in the name of Center X and State A. Accordingly, we conclude that there are no private interests involved in Center X and State A has the powers and interests of an owner.

4. Public Control and Supervision.

A majority (20 of 26) of directors on Center X's board of directors is chosen by designated county officials or, in counties where these officials do not exist, by the boards of supervisors in consultation with other local officials. Further, Act B requires Center X to meet specific requirements in a wide range of areas, such as qualification, composition and term restrictions on the boards of directors, staffing and performance requirements, and budgeting, accounting, auditing and administrative practices. Similarly, specific provisions of the contract between Center X and Department D place similar obligations and restrictions on Center X. Accordingly, we conclude that control and supervision of Center X are vested in public authorities.

5. Statutory Authority.

The legislature of State A specifically provided in Act B that the services provided by the centers are of such a special and unique nature that they cannot be satisfactorily provided by state agencies, and therefore, the centers would be operated by nonprofit corporations organized and created to provide services to developmentally disabled individuals. The State is required to provide services through the centers which are, in turn, subject to specific requirements under Act B. Accordingly, we conclude that Center X operates under the express authority of Act B.

6. Financial Autonomy/Source of Operating Funds.

We previously noted that virtually the entire operating budget of Center X comes from Department D or State A, the materials and property used by Center X to fulfill its contractual obligations belong to state A, and both Center X's bank accounts and investments are held jointly with state A. Act B provides that Department D shall act as agent for the transmittal of funds for services through Center X. Additionally, Department D is responsible for the processing, audit and payment of funds made available to Center X. Accordingly, we conclude that Center X has little or no financial autonomy and is dependent on State A and Department D for its operating funds.

**Conclusion:**

Based on the above analysis, we conclude that Center X satisfies the criteria of Revenue Ruling 57-128, and is an instrumentality of State A. The services performed by Center X's employees who are qualified participants in a retirement system within the meaning of Code § 3121(b)(7)(F) are excluded from employment for purposes of Code §§ 3101(a) and 3111(a). No opinion is expressed on whether the retirement system of State A constitutes a retirement system within the meaning of Code § 3121(b)(7)(F). The above analysis is based on the assumption that Center X employees are not covered by a section 218 agreement.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer's representative 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 a ruling, it is subject to verification on examination.

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

Sincerely,

Lynne Camillo  
Chief, Employment Tax Branch 2  
Office of Division Counsel/Associate Chief  
Counsel (Tax Exempt & Government  
Entities)