

Internal Revenue Service

Department of the Treasury

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Date:

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LEGEND:

Taxpayer =

EIN:

Corporation =

State =

State University =

Department =

Year 1 =

State University Medical School =

State University Medical Center =

State Statute A =

State Statute B =

State Statute C =

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This is in response to a ruling request submitted on behalf of Taxpayer, as amended by Taxpayer on September 20, 2000. The amended request has been further supplemented by additional documentation and correspondence. Taxpayer requests a ruling that its income is excludible from gross income for federal income tax purposes under section 115(1) of the Internal Revenue Code.

FACTS

Taxpayer is a general pathology and testing lab. Consistent with the authority granted by State Statutes A and B, and authority delegated by the State Board of Regents, the President of the State University, and certain State University officers, the Chairman of the Department (a department of the State University Medical School) formed Taxpayer in Year 1. Taxpayer was formed as the wholly owned subsidiary of the Corporation.

Taxpayer performs laboratory services and blood work in direct support of the State University Medical Center. Taxpayer also performs esoteric and highly esoteric

laboratory services to third party hospitals and laboratories. Esoteric and highly esoteric services refer to very specialized types of testing that are not efficiently handled by other laboratories.

Taxpayer provides all faculty, laboratories, and instructional support for training of medical students, graduate students, fellows, and undergraduates in clinical pathology sciences. Taxpayer's facility also houses several State University and State University Medical Center functions (in addition to pathology) at below-market rates.

Taxpayer is the principal location and source of instruction in clinical pathology sciences for students in undergraduate degrees, such as medical technicians, medical laboratory technicians, and cytotechnologists. It is also the principal location and source of instruction for medical students, pathology residents and fellows, as well as for continuing education for those working in the pathology field. Taxpayer also derives income from other educational activities.

Taxpayer represents that its Articles of Incorporation and Bylaws will be amended to meet the requirements of section 115(1), specifically to ensure that: (1) the Corporation or the Department will at all times own all stock in Taxpayer; (2) all operating revenues and surplus of Taxpayer are used for the educational mission of the Department; (3) Taxpayer will not admit partners, become a partner in any partnership, or enter into a revenue sharing or net profit sharing arrangement, and; (4) upon dissolution of Taxpayer, all assets of Taxpayer will be distributed to the Corporation or to the Department. In addition, the taxpayer represents that all profits of Taxpayer accrue to the State University.

State law and Taxpayer's amended Bylaws provide that the State constitution, statutes and regulations supercede any conflicting provisions in Taxpayer's Articles of Incorporation or Bylaws. State Statute A authorizes the State University to contract with third parties and to form organizational entities within the State University structure and to engage in enterprise operations that are in support of authorized programs within the educational role of the recipient institution. Taxpayer is prohibited by a State Board of Regents rule from providing services to persons other than members of the campus community unless the service offers a substantial and valuable educational or research experience for registered students and faculty or the service fulfills the institution's public service requirements. Taxpayer represents that, in accordance with State Statute A, no portion of the funds or proceeds of Taxpayer may be diverted from or used for purposes other than those authorized or undertaken in support of authorized programs within the educational role of the recipient institution.

The Corporation's and Taxpayer's representative has stated that the Corporation's Articles of Incorporation will be amended to satisfy the requirements of section 115(1) of the Code. State Statute C states that the State Board of Regents is the successor to and vested with all power and authority, control and management over the State University's property, real and personal, tangible and intangible. Accordingly,

as has been determined by certain courts, state law provides that the State University holds property in trust only; the property of the State University belongs to the State.

LAW AND ANALYSIS

Both Taxpayer and the Corporation have executed a power of attorney with respect to the matters discussed in this ruling.

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of an essential governmental function and accruing to a state or political subdivision of a state.

All the facts and circumstances relating to the organization to determine whether the organization performs an essential governmental function and whether the income of the organization accrues to a state or political subdivision of the state.

Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization formed, operated and funded by political subdivisions to pool their casualty risks and other risks arising from their obligations concerning public liability, workers' compensation, or employees' health obligations. The ruling states that the income of such an organization is excluded from gross income under section 115(1) so long as private interests do not participate in the organization or benefit more than incidentally from the organization. The benefit to the employees of the insurance coverage obtained by the member political subdivisions was deemed incidental to the public benefit.

Rev. Rul. 77-261, 1977-1 C.B. 45, holds that income from a fund, established under a written declaration of trust by a state, for the temporary investment of positive cash balances of a state and its political subdivisions, is excludable from gross income under section 115(1). The ruling reasons that the investment of positive cash balances by a state or political subdivision in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and raise revenue.

Rev. Rul. 71-589, 1971-2 C.B. 94, provides that the income from property held in trust by a city that was to be used by the city for certain charitable purposes is not subject to federal income tax. Although Rev. Rul. 71-589 does not explicitly so state, the holding in the revenue ruling means that a determination was made that the income in question was derived from the exercise of an essential governmental function and accrued to a political subdivision within the meaning of section 115(1) of the Code. Rev. Rul. 71-589 specifically mentions the support of a hospital as one of the functions such trust might perform.

Promotion of public health and the support of medical facilities are well-established functions of state and local governments and are essential governmental functions. Education is also an essential government function. Taxpayer's activities

promote health, support medical facilities, and are educational. Taxpayer's income, therefore, derives from the provision of services that are established functions of state and local governments and are essential governmental functions within the meaning of section 115(1).

In addition to deriving income from the performance of an essential governmental function, income of Taxpayer must accrue to the State or a political subdivision of the State. All income of Taxpayer accrues to the Corporation. In the event of dissolution, all assets (after payment of liabilities) of the Corporation accrue exclusively to the State University for its Medical Center, or if not to the State University, accrue to another entity owned by the State that meets the requirements of section 115 of the Internal Revenue Code or that meets the requirements of an integral part of the State. Accordingly, the income of Taxpayer accrues to the State.

Based on the information submitted, representations made and authorities cited, we conclude that Taxpayer's income is excludible from gross income for federal income tax purposes under section 115(1) of the Internal Revenue Code. This ruling is contingent upon Taxpayer and the Corporation amending their respective Articles of Incorporation and Bylaws as represented. Because this ruling is dependent on the amendment of these documents, the ruling applies only for periods on and after the date(s) on which the amendments are effective.

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

Sincerely,
Elizabeth Purcell
Chief, Exempt Organizations Branch 2