

Internal Revenue Service

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CC:TEGE:EOEG:E02 – PLR-160165-03

Date:

March 18, 2004

DO: TY:

Legend

A =

State =

Department =

Commissioner =

Act 1 =

Act 2 =

Act 3 =

B Plan =

C Plan =

Year 1 =

Year 2 =

Event 1 =

Date 1 =

Disaster 1 =

Disaster 2 =

Disaster 3 =

\$X =

B =

C =

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Dear _____ :

This is in response to your letter dated October 13, 2003 as supplemented by a letter signed December 2, 2003 requesting the following rulings:

1. Whether A will be an integral part of the State or a political subdivision of the State and its income will be exempt from federal income tax?
2. Whether the debt obligations issued by A will constitute obligations of a political subdivision thereof within the meaning of Internal Revenue Code section 103?

FACTS AND REPRESENTATIONS

A is a non-profit public corporation that was formed by the State legislature by Act 1. Its purpose is to operate insurance plans that function exclusively as residual market mechanisms to provide essential property insurance for residential and commercial property, solely for applicants who are in good faith entitled to, but are unable, to procure insurance through the voluntary market. A will take over operation of B Plan and C Plan through a Plan of Operation. A's assets are not part of the general fund of the State and are not subject to debts, claims or liabilities of the State so that the funds will be preserved for the activities of the Plans. A is subject to State's open meeting laws, public record laws and public bid laws for the procurement of contracts which are imposed by state law on public bodies.

State had instituted B Plan to provide a residual market for adequate insurance on property in the state in Year 1 as a result of civil unrest and urban civil disobedience causing property damage in State's inner cities. Market demands led B Plan to be expanded to include any area not within the designated coastal plain area set forth in Act 2. State also instituted C Plan in Act 3 to provide adequate insurance on property in the coastal areas of the state as a result of the damage caused in Year 2 by Event 1. Both plans were recreated and continued by Act 1 as insurance programs of A.

All insurers authorized to write property insurance covering risks located in State are required to participate in B Plan and C Plan as a condition of their authority to transact business in the state. State mandated participation is intended to prevent the burden of insuring such risks falling upon a few, public-spirited insurers and also designed to assure an adequate market for fire, extended coverage and vandalism and malicious mischief and, if necessary, homeowners insurance in coastal and noncoastal areas of the state. Participating insurers have no financial interest in the assets or revenue of A.

Since Date 1, the State has experienced catastrophic losses resulting from what had been considered routine or relatively minor natural disasters. During this period, losses

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in excess of \$X over aggregate premiums were experienced by participants in B Plan and C Plan resulting from Disaster 1, Disaster 2 and Disaster 3. These losses required substantial assessments against participating insurers which were only recovered after the fact through approved rate increases. As a result, you represent that insurers have become reluctant to write insurance in State. Act 1 was enacted to preserve the normal insurance market while strengthening the residual market by giving participating insurers the ability to recoup losses from all insureds. Act 1 was determined to be necessary for the economic welfare of the state.

A has statutory authority to issue policies of insurance to eligible applicants, purchase reinsurance, borrow funds, sue or be sued, and enter into contracts. A is required to keep separate accounts for the two Plans, retain profits and excess reserves to offset deficits, and develop and annually reassess a prudent reinsurance program for the Plans. It is intended that A's income and operations be tax-exempt and that it have authority to issue tax-exempt bonds or have such bonds issued on its behalf.

A's Board of Directors is composed of 1) the Commissioner of the Department, or an employee of the Department as his designee; 2) State Treasurer or an employee of the Department of the Treasury as his designee; 3) the Chairman of the House Committee on Insurance, or a member of the committee designated by the Chairman; 4) the Chairman of the Senate Committee on Insurance, or a member of the committee designated by the Chairman; 5) Five representatives appointed by the governor that include one from the list of two nominees of domestic insurer with the largest direct written premium in the state of the subject lines of business, one from two nominees from an insurer with at least one percent of the aggregate state-wide direct written premium of the subject lines of business, and three representatives appointed at large; 6) two members appointed by the Commissioner from a list of nominees of two organizations of Insurance Agents; three members appointed by the Governor from a list of nominees of three organizations of insurers; and a member appointed by the Governor from a list of nominees from the insurer with largest direct written premium in the state of subject lines of business.

Members of the A's Board of Directors serve at the pleasure of the respective appointing party. All persons of A's senior management shall be engaged in by the Commissioner and serve at the Commissioner's pleasure. All compensated employees of A, except members of the governing board, are subject to the provisions of the State Constitution relating to prohibitions on political activities as if they were employees of State.

The Act and the Plan of Operation provide all insurers writing policies of property insurance in State shall participate in Plans B and C in the proportion that the net direct premium of such participant in the state during the preceding calendar year bears to the

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aggregate net direct premiums written in the state by all assessable insurers as certified by B. A's Plans of Operation are subject to the oversight of the House and Senate Insurance Committees of the state legislature.

Assessable insurers shall not participate in the gains or losses of either of the Plans. There are also regular assessments to be levied on assessable insurers, market equalization charges to be levied on the policyholders of the two Plans and emergency assessments to be levied on all policyholders for the applicable lines of business.

When a deficit incurred in a particular calendar year is not greater than ten percent of the aggregate statewide direct written premium, the entire deficit shall be recovered through regular assessments of the assessable insurers. Assessable insurers are permitted to recoup all regular assessments from their voluntary policy holders by applying a surcharge to all policies for the subject lines of business. The surcharge shall be a percentage of premium, but shall not be considered premium.

When a regular assessment is levied, all policy holders of Plans B and C shall be subject to a market equalization charge. The market equalization charge shall be a uniform percentage of premiums as a ratio of the total regular assessment levied by A to the total aggregate statewide direct premiums of the subject lines of business for the prior calendar year, but shall not be considered premium.

When the deficit exceeds the amount that will be recovered through regular assessments, the Board of Directors shall levy, after verification by the Department, emergency assessments for as many years as necessary to cover the deficits. The emergency assessments shall be levied on all assessable insureds upon insurance or renewal of policies. Emergency assessments will be collected from assessable insureds by assessable insurers and Plans B and C. Emergency assessments shall be a uniform percentage of premiums, but shall not be premiums.

Premium rates shall be set by the Board of Directors in accordance with provisions of Act 1 at rates that will not be competitive with the voluntary market. In addition to the normal premium tax provided by State law, A will impose and collect an additional amount equal to the premium tax to augment A's financial resources which shall be retained by A as a contribution from State.

A is required to file annual and quarterly statements with B. A and the Plans shall be subject to examination of the Commissioner and the Legislative Auditor. A is authorized to pledge the proceeds of assessments, insurance and reinsurance recoverables, surcharges and other funds available to A as revenue sources to secure bonds or other indebtedness and financing mechanisms as a result of deficits or events giving rise to

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deficits to assist A in covering claims and expenses attributable to catastrophes. All bonds and other indebtedness of A must be approved by C.

Upon depopulation of the Plans and a determination of the governing board that the declaration and purpose as set forth in Act A no longer requires operation of the Plans, and with the approval of the State Senate and House Committees on Insurance and the Commissioner, A shall effectuate a plan of dissolution. Upon dissolution, all remaining assets after the payment of all debts, liabilities and obligations, including reasonable reserves for contingent liabilities or obligations, shall become property of State and be deposited in State's general fund.

LAW

Integral part

In general, if income is earned by an enterprise that is an integral part of a state or a political subdivision of a state, that income is not taxable in the absence of specific statutory authorization to tax that income. See Rev. Rul. 87-2, 1987-1 C.B. 18; GCM 14407, C.B. XIV-1, 103 (1935), superseded by Rev. Rul. 71-131, 1971-1 C.B. 28.

In Maryland Savings-Share Insurance Corp. ("MSSIC") v. United States, 308 F. Supp. 761, rev'd on other grounds, 400 U.S. 4 (1970), the State of Maryland formed a corporation to insure the customer accounts of state chartered savings and loan associations. Under MSSIC's charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Only three of eleven directors were selected by state officials. The district court rejected MSSIC's claim of intergovernmental tax immunity because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Thus, the imposition of an income tax on MSSIC would not burden the State of Maryland. Although the Supreme Court reversed the lower court on other grounds, it agreed with the lower court's analysis of the instrumentality and section 115 issues. MSSIC, 400 U.S. at 7, n.2.

In State of Michigan and Michigan Education Trust v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992), the court held that the investment income of the Michigan Education Trust (MET) was not subject to current taxation under section 11(a) of the Code. The court's opinion is internally inconsistent because it concludes that MET qualifies as a political subdivision of the State of Michigan (*Id.* at 825), that MET is "in a broad sense" a municipal corporation (*Id.* at 826), and that MET is in any event an integral part of the State of Michigan (*Id.* at 829). Moreover, the court's reliance on the factors listed in Rev. Rul. 57-128, 1957 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from a

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state. The factors in the revenue ruling do not determine whether an enterprise is considered to be a separate entity or an integral part of the state.

Section 301.7701-1 et seq. of the Procedure and Administration Regulations, the so-called "check-the-box" regulations, support the position that an entity that is recognized as separate from a state or political subdivision for local law purposes may still be an integral part of that state or political subdivision. Section 301.7701-1(a)(3) provides, in part, that:

An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.

In determining whether an enterprise is an integral part of a state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise.

A was created by statute for the public purpose of insuring the existence of an orderly market of types of insurance offered by B and C Plans, for State residents and businesses.

Under the legislation, A will be supervised and controlled by State. The members of the board of directors include public officials and their designees and members appointed by the Commissioner or Governor. All members of A's senior management are engaged in by the Commissioner and serve at the Commissioner's pleasure. All of A's compensated employees, except for members of A's Board, are subject to provisions of the State Constitution relating to prohibitions on political employees as if they were state employees. A's operations are subject under the statute to continuous review and supervision by the Department and the House and Senate Insurance Committees of the State legislature. Its Governing Board meetings are conducted in accordance with the State Open Meetings Law. A must receive approval for its Plan of Operation from the Department, and must file regular financial reports. The rates A will be allowed to charge are specified in the proposed legislation and the circumstances under which assessments to cover deficits can be made will be subject to verification by the Department. All of New Fund's activities, and its employees, will be subject to the supervision and control of the Commissioner and the State legislature. All bonds and other indebtedness of A must be approved by a state commissioner. Thus, State will exercise a significant degree of control over A.

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Under the proposed legislation, A will also collect an amount equal to the premium tax and will retain such amount to augment its resources. Accordingly, State will provide a substantial financial commitment to A.

Issue 2 Bonds

I.R.C. § 103(a) provides that except as provided in subsection(b), gross income does not include interest on any State or local bond.

I.R.C. § 103(c)(1) provides that the term “State or local bond” means an obligation of a State or political subdivision thereof.

We have already determined that A is an integral part of State. Obligations issued by A will thus be obligations issued by or on behalf of State, and will constitute obligations of a state or political subdivision within the meaning of section 103(c)(1) of the Internal Revenue Code.

Conclusions

1. A constitutes an integral part of State, and its income will be exempt from federal income tax.
2. Obligations issued by A will constitute obligations of a state or political subdivision within the meaning of section 103(c)(1) of the Code.

We are not ruling as to whether the interest of any specific obligation that may be issued by A will be exempt from taxation.

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.

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.

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In accordance with the Power of Attorney on file with this office, the original of this letter is being sent to your authorized representative and you are being sent a copy.

Sincerely,

Barbara E. Beckman
Assistant Chief, Exempt Organizations
Branch 2
Office of Division Counsel/Associate Chief
Counsel
(Tax Exempt & Government Entities)

Enclosures:

Section 6110 copy of letter

cc: