

## Internal Revenue Service

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## Legend

Taxpayer =

State =

Statute A =

Statute B =

Date A =

Date B =

Statute C =

Statutes X, Regulations, =

Statute D =

Dear :

This is in reply to your letter dated April 28, 2005, and subsequent correspondence, in which you request certain rulings on behalf of Taxpayer.

#### FACTS

Taxpayer has made the following representations of fact. Taxpayer is a nonprofit corporation formed by two State public school districts pursuant to the authority described in Statute A for the purpose of acting as a public procurement unit within the meaning of Statute B. Taxpayer's sole purpose is to procure goods and services for public school districts and Taxpayer's other members. Through cooperative purchasing power, Taxpayer enables its members to purchase a range of goods and services at reduced prices. The expense of organizing and operating Taxpayer is borne by its members.

Taxpayer has only one class of members. Entities may become members of Taxpayer after properly executing a written contract or intergovernmental agreement with Taxpayer.

Taxpayer filed amended articles of incorporation with State on or about Date A ("Amended Articles"). Taxpayer's Amended Articles provide that its members must be public school districts and governmental public entities that are political subdivisions of State or other states. In addition, nonprofit educational or public health institutions of State or of other states may become members, but only to the extent that such entities are political subdivisions for purposes of federal income tax or meet the requirements of § 115 of the Internal Revenue Code (the "Code"). According to Taxpayer's written policy manual, a nonprofit educational and healthcare entity must include documentation when requesting membership with Taxpayer to substantiate that the entity is a political subdivision for purposes of federal income tax or meets the requirements of § 115 of the Code. Taxpayer has identified certain current members that do not meet the membership requirements provided in the Amended Articles, but represents that the membership of all such entities will be terminated effective no later than Date B.

In accordance with its Amended Articles, Taxpayer may not issue shares of stock nor declare or pay dividends. No part of Taxpayer's net earnings may inure to the benefit of, or be distributable to, any director or officer of Taxpayer nor to any other individual. Reasonable compensation for services rendered and payments and distributions in furtherance of its purposes, as described in Taxpayer's organizing

documents, may be made, however. In the event of Taxpayer's dissolution or final liquidation, the Amended Articles provide that any property and assets remaining after the satisfaction and discharge of Taxpayer's liabilities and obligations shall be distributed solely to the members of Taxpayer; remaining assets are to be distributed to members by averaging the purchases made by each member, up to and including the three years prior to dissolution, to determine the percentage of ownership or final distribution for each member. Should only liabilities and obligations remain at the time of dissolution, the same formula is to be used to determine each member's percentage of the total obligation at dissolution.

In accordance with Statute C, Taxpayer must, upon request, provide all documentation concerning any cooperative purchasing transaction that it administers to the State's auditor general. Taxpayer must also comply with all procurement laws applicable to the school districts participating in cooperative purchasing transactions administered by it, and comply with all aspects of Statutes X, Regulations, and Policies. Taxpayer is governed by a board of trustees, at least three of whom must be elected officials or employees of public entities within State. Members of the board of trustees must meet the qualifications set forth in Statute D.

Taxpayer requests the following rulings:

(1) Taxpayer's income is derived from the exercise of an essential government function; and

(2) Taxpayer's income accrues to one or more political subdivisions of State, and that, Taxpayer's income, therefore, is not included in the definition of taxable gross income pursuant to § 115(1) of the Code.

## 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 is excludable from gross income for federal income tax purposes under § 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 public utilities 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 properly to conduct.

Rev. Rul. 90-74, 1990-2 C.B. 34, holds that the income of an organization formed, funded, and operated by one or more political subdivisions to pool risks (casualty, public liability, workers' compensation, and employees' health) is excluded from gross income under §115(1) of the Code. In this ruling, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

In order for Taxpayer's income to be excluded from gross income under § 115(1) of the Code, its income must be derived from a public utility or the exercise of an essential government function. Taxpayer sole purpose is to act as a public procurement unit so as to pool its members' resources to procure goods and services at more competitive prices for its members, all of which are public school districts, political subdivisions, or other entities meeting the requirements of § 115 of the Code. The types of benefits provided by Taxpayer are similar to those described in Rev. Rul. 90-74. Like the organization described in Rev. Rul. 90-74, Taxpayer performs an essential governmental function within the meaning of § 115(1).

In addition, Taxpayer's income must accrue to a state or any political subdivision thereof in order to meet the requirements of § 115(1). Taxpayer's income accrues to its members through the procurement of goods and services for its members. Upon dissolution, all assets remaining after the satisfaction of liabilities are distributed on a pro rata basis to Taxpayer's members, all of which will be public school districts, other political subdivisions of State or other states, or entities that meet the requirements of § 115 of the Code as of Date B. No part of Taxpayer's net earnings may inure to the benefit of or be distributable to private persons, other than incidentally or as reasonable compensation for services rendered and payments and distributions in furtherance of its purposes. Accordingly, Taxpayer's income accrues to a state or any political subdivision thereof within the meaning of § 115(1) of the Code effective as of Date B.

Based on the information submitted and representations by Taxpayer, we conclude as follows:

- (1) Taxpayer's income derives from the exercise of an essential government function; and
- (2) Taxpayer's income accrues, effective as of Date B, to one or more political subdivisions within the meaning of § 115(1).
- (3) Accordingly, Taxpayer's income is excluded from the definition of taxable gross income pursuant to § 115(1) of the Code.

This ruling is based on the information and representations provided by Taxpayer. Because this ruling is contingent on changes to the composition of Taxpayer's membership, this ruling applies only for periods on and after the date such changes, consistent with the membership requirements stated in the Amended Articles, are effective.

No opinion is expressed concerning the Federal tax consequences of Taxpayer under any other provision of the Code other than that specifically stated herein.

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

Sincerely,

David L. Marshall  
Branch Chief  
Exempt Organizations Br. 2  
(Exempt Organizations/Employment Tax/  
Government Entities)  
(Tax Exempt & Government Entities)

cc: