

Internal Revenue Service

Department of the Treasury

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Person To Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:EO2;PLR-103614-03

Date: May 13, 2003

DO:

Legend

Corporation =
Parent =
State =
Section w =
Section x =
\$y =
\$z =

Dear :

This is in response to a letter, dated December 6, 2002, from your authorized representative, requesting a ruling that the income of the Corporation will be excludable from gross income under § 115 of the Internal Revenue Code ("Code") and that the Corporation is not required to file annual information returns.

FACTS

Corporation is incorporated under the laws of State and is a wholly-owned subsidiary of Parent. Corporation represents that, pursuant to a letter from the Internal Revenue Service, Parent's income is excludable from tax under § 115 of the Code. Parent was formed by counties of State for the purpose of providing the counties the opportunity to pool certain liability risks. Parent is governed by a board of directors elected from member counties. Upon dissolution of Parent, all of its assets remaining after payment of liabilities will be distributed to the member counties in proportion to their financial contribution.

Corporation was formed for the purpose of engaging in the insurance business by providing insurance solely to State's municipalities, as defined in §§ w and x of State statutes. The insurance protects State municipalities and other State governmental entities from liability incident to carrying out their essential governmental functions. In addition, State statutes require municipalities to defend and indemnify law enforcement officers and other public officials who may be found liable to third parties while acting in their official duties. Corporation is organized under State law, and has been issued a certificate of authority by the State Commissioner of Insurance. Corporation has been authorized by the State Commissioner of Insurance to provide the following types of insurance to State municipalities and other State government entities: (1) liability and incidental medical expense insurance, (2) automobile and aircraft insurance, and (3) worker's compensation insurance.

Corporation has one share of common stock, without par value, that is owned by Parent. The share was issued in consideration of payment to Corporation by Parent of \$ y, which is maintained by Corporation as paid in capital. In addition, Parent has contributed \$ z to Corporation as expendable surplus.

Under the Corporation's articles of incorporation, Parent is the only permitted shareholder and has the sole right to receive the net assets of Corporation upon dissolution.

Each of Corporation's five directors is an elected official of a county in State. The board of directors will be increased to add two directors who will represent municipalities. These directors will be elected by Parent.

Corporation will collect premiums from State municipal and State governmental entity policyholders and will pay claims from those funds and any investment earnings on those funds. The policies will be nonassessable. After paying claims and expenses and providing for required capital and claim reserves, all remaining funds will remain as capital of Corporation or will be paid to Parent as dividends. No private parties may receive any of Corporation's income.

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 governmental function and accruing to a state or political subdivision of a state.

When determining if § 115(1) of the Code applies, the Service considers all the facts and circumstances relating to the organization to determine: (1) whether the organization performs an essential governmental function, and (2) whether the income of the organization accrues to a state or political subdivision of a state. The determination whether a function is an essential governmental function depends on the facts and circumstances of each case.

Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization formed, operated,

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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 § 115(1) of the Code 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 case balances of a state and its political subdivisions, is excludable from gross income under § 115(1) of the Code. 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.

Corporation was established to provide insurance against liabilities arising from the conduct of governmental functions by State municipalities and their employees. By providing insurance coverage on a pooled basis, the municipalities are fulfilling their obligation to protect their financial integrity. Further, Corporation provides the means for municipalities to fulfill their statutory requirement to provide for insurance coverage for third party claims against employees while acting within their official duties. Any private benefit to employees from insuring against these various risks is incidental to the public benefit. Corporation was created to further the legitimate governmental public functions of State's municipalities. Based on Rev. Rul. 90-74 and Rev. Rul. 77-261, Corporation performs an essential government function within the meaning of § 115(1) of the Code.

In addition to the performance of an essential governmental function, for Corporation to qualify to exclude its income from gross income under § 115(1) of the Code, income of Corporation must accrue to State or a political subdivision of State.

Corporation is wholly-owned by Parent, an entity the income of which corporation represents is excluded from income tax under § 115(1). No part of the net earnings of either Corporation or Parent inures to the benefit of or is distributed to any private entity or individual. Upon dissolution of Corporation, all of its net assets will be distributed to Parent, which is controlled by political subdivisions of State. In addition, after paying claims and expenses, as well as providing required capital and claim reserves, all funds not remaining in Corporation as capital will be paid to Parent. Accordingly, the income of Corporation is excludible from gross income under § 115(1) of the Code.

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CONCLUSION

Based on the information and representations submitted by Corporation, we hold that the income of Corporation is excludible from gross income for federal income tax purposes under § 115(1) of the Code.

No opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Code.

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.

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

Sincerely,

Elizabeth Purcell, Chief
Exempt Organizations Branch 2
Office of Division Counsel/Associate Chief
Counsel
(Tax Exempt and Government Entities)