



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler  
Assistant Chief Counsel (Field Service)  
CC:DOM:FS:FI&P

SUBJECT: I.R.C. § 115(1)

This Field Service Advice responds to your supplemental request for advice dated April 5, 2000. Previous Field Service Advice was issued with respect to this case on July 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

**DISCLOSURE STATEMENT**

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official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND:

Fund	=
State	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Date 1	=

ISSUE:

Whether Fund's exemption under section 501(c)(27)(B) of the Code on Date 1 impacts a determination that Fund's income was not exempt under section 115(1) during the years under examination.

CONCLUSION:

Section 501(c)(27)(B) of the Code is effective for years beginning after December 31, 1997. Fund's exemption under section 501(c)(27)(B) does not impact the years under examination that are prior to the effective date of that provision.

FACTS:

The facts of this case are set forth in detail in the prior Field Service Advice issued July 13, 1999, and are incorporated herein by reference.

Fund is a private, nonprofit corporation that was authorized by an amendment to State's constitution and created pursuant to a related State statute in Year 1. The original enabling legislation provided that it is the purpose of Fund to provide a residual market for employers that have in good faith been unable to obtain workers' compensation insurance in the voluntary market; to provide a competitive market for preferred risk policies; and to insure that rates charged are adequate to provide solvency and self-funding of the corporation.

In Year 2, Fund submitted a private letter ruling request for exemption under section 115. Subsequently, in Year 3, the Service advised Fund that it was

tentatively adverse to the request for exemption under section 115. In response to the concerns raised by the Service during the ruling process, State passed legislation providing that Fund is backed by the full faith and credit of State and contributions by the State are not subject to repayment by Fund. In Year 4, Fund withdrew its request for a ruling under section 115.

Fund has filed Forms 1120-PC since its inception in Year 1, reporting zero tax liability based on its contention that its income is excluded from taxation under section 115 of the Code.

Recent information you provided indicates that State passed legislation and proposed a constitutional amendment that extinguishes the full faith and credit of the State for Fund's obligations. Under revised statutes, power to dissolve or otherwise terminate the corporation shall rest solely with the commissioner of insurance or the Fund's policyholders. In addition, the current statute provides that assets remaining on dissolution of Fund are to be held in trust to pay the claims of policyholders and beneficiaries and any remaining assets shall be transferred to the State.

On Date 1, the Service issued a Determination Letter granting Fund exemption under 501(c)(27)(B) of the Code.

### LAW AND ANALYSIS

Income earned by an entity organized separately from a state or political subdivision may be exempt under section 115 of the Internal Revenue Code. Specifically, section 115(1) provides that income is excluded from taxation if it is derived from the exercise of any essential governmental function and accrues to a state or any political subdivision.

Section 115(1) does not apply, however, if there is more than an incidental private benefit connected with the income generated by the activity. Rev. Rul. 90-74, 1990-2 C.B. 34. In the cited ruling, the Service considered the income of an organization formed, operated and funded by political subdivisions to pool their casualty risks, or other risks arising from their obligations concerning public liability, workers' compensation, or employees' health. The ruling held that such income is excluded from gross income under section 115(1) if private interests do not participate in the organization or benefit more than incidentally from the organization. Id. The accrual test is satisfied because the income was used to reimburse casualty losses incurred by the counties or to reduce annual fees the member counties would otherwise be required to pay. Furthermore, upon dissolution, assets of the entity are distributed to the state. Id.

As discussed in the prior FSA, the facts indicate Fund's income did not accrue to State during the years under examination. The commercial insurance provided by Fund and the resulting benefit to private employers appear to be a private benefit that would preclude the application of section 115(1).

While it is our opinion that Fund does not meet the requirements of section 115(1), the Taxpayer Relief Act of 1997 provides an alternative means of exemption for certain organizations. Specifically, section 501(c)(27)(B), provides an exemption for any organization (including a mutual insurance company) if - -

(i) such organization is created by State law and is organized and operated under State law exclusively to - -

(I) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if such insurance is not purchased by an employer, and

(II) provide related coverage which is incidental to workmen's compensation insurance.

(ii) such organization must provide workmen's compensation insurance to any employer in the State (for employees in the State or temporarily assigned out-of-State) which seeks such insurance and meets other reasonable requirements relating thereto,

(iii) (I) the State makes a financial commitment with respect to such organization either by extending the full faith and credit of the State to the initial debt of such organization or by providing the initial operating capital of such organization, and (II) in the case of periods after the date of enactment of this subparagraph, the assets of such organization revert to the State upon dissolution or State law does not permit the dissolution of such organization, and

(iv) the majority of the board of directors or oversight body of such organization are appointed by the chief executive officer or other executive branch official of the State, by the State legislature, or by both.

The cited provision is effective only for tax years beginning after December 31, 1997. Despite the Service's recognition of Fund as an organization exempt under section 501(c)(27)(B), this provision is prospective only and does not impact the years under examination prior to 1998.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Our assessment of the litigation hazards with respect to section 115(1) are discussed in the prior Field Service Advice.

Regarding section 501(c)(27)(B), it is clear that this provision only applies to years beginning after December 31, 1997. [REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

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<sup>1</sup> [REDACTED]

[REDACTED]

[REDACTED]

Please call if you have any further questions.

By: Joel E. Helke

JOEL E. HELKE  
Branch Chief  
Financial Institutions & Products

cc: