Internal Revenue Service

Department of the Treasury

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December 1, 1998

LEGEND:

City =
State =
Utility =

Division =

Board =
Ordinance =

Valley =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
B =
C =
D =
E =
F =
G =
H =
X =
Y =
Z =

This is in response to a letter dated May 22, 1998, and subsequent correspondence dated October 22, 1998, requesting (1) a ruling concerning the exclusion of income of Utility from gross income under section 115 of the Internal Revenue Code (the "Code") after the acquisition of all Utility's outstanding stock by the City, and (2) a ruling that the City and Utility will not recognize gain pursuant to § 336 or 337 or any other provision of

the Code upon the City's purchase of Utility's stock or by reason of Utility's subsequent exclusion of income under § 115(1). Pursuant to § 8.02 of Rev. Proc. 98-1, 1998-1 I.R.B. 7, the response to the second issue will be issued under separate cover.

FACTS

Utility is currently a for-profit stock corporation incorporated under the laws of the State. The City is a municipal corporation pursuant to the laws of the State and as such is a political subdivision of the State. Utility supplies water for public and private use to the City pursuant to the Ordinance.

Utility provides potable water to domestic, commercial, and industrial users within the City. Activities in support of, and in conjunction with, Utility's business include water production from groundwater sources located west of the City, chlorination of the water, monitoring of the quality of the water, delivery to customers via a system of water pipelines, and billing of Utility's services to its customers. Utility also provides billing services to the City on a fee-for-service basis in connection with the City's sanitary sewer collection system and wastewater treatment facility. Utility reports the results of its business activities to the City annually.

All of Utility's operations are conducted pursuant to a nonexclusive franchise agreement with the City, as authorized by state statute. The current franchise was granted in Year 3, pursuant to the Ordinance for an original term of F years. In Year 5, the term of the franchise agreement was extended to allow time for the negotiation of the acquisition of all Utility's stock by the City. In general, the franchise agreement provides Utility (1) shall supply potable water to the inhabitants of the City; (2) shall provide an adequate water supply for fire protection; (3) shall meter the quantities of water provided to customers; (4) may make use of the City's rights-of-way and other public grounds for installation of improvements; (5) may make and enforce reasonable rules and regulations pertaining to operation of its potable water supply business; and (6) shall pay to the City as a franchise fee an amount equal to two percent of Utility's gross receipts. The franchise agreement gives the City the right to purchase, after the tenth year of the agreement, the assets of the Company at fair value.

The major assets of the Utility include six water appropriation rights granted by the State for the withdrawal of groundwater from sites west of the City, pump stations, wells,

storage facilities, water pipelines and an office building along with the underlying real property. Utility has long term debt of approximately $X consisting predominately of industrial development bonds. These bonds were used to underwrite the construction of a new water storage facility and related improvements.

Utility was formed in Year 1, at which time the City had approximately B residents. The City has grown to about C residents in Year 2 and D residents in Year 4. Currently, the population is approximately E residents. As this growth occurred, the City and Utility cooperated to assure an adequate public water supply. In the midst of the initial term of their franchise agreement, the City and Utility agreed that all future water main and lateral pipelines would be installed and owned by the City. Accordingly, the City now owns approximately one-half of the public water distribution system located within the City. This percentage will increase as the City continues to grow and new water lines are installed. Despite the City's ownership of this portion of the distribution system, Utility is the operator of the entire water supply and distribution system. There is no agreement between the City and Utility addressing the use of the City-owned water lines. Other than the two-percent franchise fee, the City derives no revenue from Utility's use of the City's water lines. The City does own and operate the sanitary sewer and wastewater treatment facilities serving the City.

The City and Utility have conducted negotiations with respect to the City's right to purchase Utility's assets under the franchise agreement. Out of these negotiations, the parties have entered into a letter of intent under which the two parties agreed that the City will acquire 100% of all of the outstanding stock of Utility at a price of $Y per share and the City will operate Utility as a wholly owned subsidiary. Publicly elected City council members will serve as the board of directors of Utility after the acquisition. This board of directors will function with all the same powers, duties, limitations, and obligations of the directors of any State-chartered corporation. The board will have the power to appoint the officers of Utility. Because of the years of experience and expertise of the present officers in operating Utility in a professional and efficient manner, however, the present officers, and all other existing employees, will be retained in their current positions for the foreseeable future.

After acquisition of Utility by the City, Utility's status under State law will not change. Utility, as a wholly owned subsidiary of the City, will continue to operate under a

franchise agreement with the City. The City is not likely to continue to pay Utility for its services in billing and collecting sanitory sewer statements. No refinancing of Utility's debt structure is expected.

The business reasons for the transaction evolve primarily out of the City's continued growth and the City's need to provide an adequate public water supply system in the face of such growth. The population of the City is growing at the rate of G% per year. During the past year the geographic area of the City has increased in total acreage by H%.

The City's acquisition of the stock of Utility will allow the City to consolidate the ownership of the water distribution system, currently split between the City and Utility, under common control. In addition, the acquisition provides public control of the water appropriation right now held by Utility. In light of the City's growing demand for water and the need to plan for additional sources of water supply, it is essential that the City secure control of its existing water supply sources.

This need is evidenced by the fact that Utility has pumped water quantities in excess of its maximum appropriation established by the Division in five of the last ten years. Because of the heavy usage of groundwater from the lower Valley, the Division is unlikely to increase Utility's maximum appropriation rights.

The City's sole ownership and oversight of the operation of its public water supply system will not only facilitate the acquisition of additional sources of water but also will allow for the implementation of further water conservation measures and planning for development of additional water storage and distribution facilities. The City's ownership of the water supply system will allow closer coordination with other communities in the area now seeking to identify and develop public water supply sources.

The City's ability to act authoritatively in such coordination efforts is now significantly limited because of Utility's control of the water system. A failure to provide adequate water supplies through securing additional supply sources and increasing conservation measures will hamper the economic development of the City. The elimination of Utility's private enterprise profit motive will allow additional conservation measures to be implemented. The City's acquisition of Utility will allow the City to focus on such efforts and allow

coordination of the related economic development initiatives and the resulting improvements of the water system's infrastructure.

These efforts to address the City's growing water needs will require substantial capital outlays. This raises concerns whether Utility is or will be adequately capitalized and able to meet such capital outlays if the water system remains in the private hands of Utility. The existing franchise agreement requires extension of Utility's water distribution system only when developers agree to underwrite the cost. The City's acquisition of the water system will resolve the concerns with capital financing for meeting the City's future water system needs. City ownership will allow the creation of reserves within a water fund to finance needed infrastructure improvements and will provide other public sources of financing such improvements to and expansion of the water system. This financing concern is evidenced by the present need for the construction of a $Z water treatment facility and the construction of new water storage facilities for recently annexed portions of the City.

The City's acquisition of Utility's stock is in accord with the overwhelming majority practice in the State. Currently, the City is one of the only two State municipalities served by a private water utility. State municipalities are authorized both by state constitutional provisions and state statute to own and operate utilities. Likewise, State municipalities are authorized to own all types of property including intangible property such as corporate stock.

In view of the capital requirements necessary to finance the needed water supplies and water treatment and storage facilities demanded by the City's rate of growth, it is unlikely that Utility will declare and pay dividends in the foreseeable future. Nonetheless, Utility's earnings reduce the need for the City to issue municipal bonds or obtain other financing at a cost to the City. Any dividends paid in future years would directly benefit the City's property owners through reduced ad valorem taxes.

The City and Utility represent that Utility's activities are and will be limited to the provision of water service and will be conducted solely for the benefit of the City and the community to which it provides water service. By acquiring Utility, the City seeks, among other things, to position itself to foster further economic development within its jurisdiction and to achieve economies of scale. The City will own all of the outstanding stock of Utility and, through its control of Utility's Board of Directors, will effectively arrange for the management of its

day-to-day operations. All directors of Utility will be public officials.

The City and Utility further represent that the articles of incorporation will be amended to provide that all of the outstanding stock of Utility will at all times be owned either by the City, another political subdivision of the State, or some other governmental entity. The articles of incorporation will be amended to provide that no earnings or assets of Utility will inure to the benefit of, or be distributed to, any private shareholder or individual, except that Utility may pay reasonable compensation and may expend funds in the furtherance of its activities as a public utility. Finally, the articles of incorporation will be amended to provide that, in the event of Utility's dissolution, after payments of its debts and obligations, all of its assets will be distributed to the City, another political subdivision of the State, or other governmental entity specified by Utility's board of directors.

The City and Utility represent that:

(a) In order to finance the acquisition of Utility's outstanding stock, the City will issue revenue bonds (the "Bonds"). The proceeds of the Bonds will be used solely to purchase the outstanding stock of Utility. The Bonds will be without recourse to the general assets of the City and secured only by a pledge of, and payable from, Utility's assets and revenues (the "Collateral").

(b) The Bonds will not be a general obligation of the City or any other governmental entity and neither the credit, the revenues, nor the taxing power of the City or any other governmental entity will be pledged to the payment of the Bonds. In addition, no deficiency judgment may be rendered against the City or any other governmental entity for any amounts due on the Bonds that are not paid from the Collateral.

(c) The terms and conditions of the Bonds will be designed so that all payments of principal and interest thereon will be fully funded from the Collateral and neither the City nor any other governmental entity will provide additional funding for the payment of such principal and interest beyond the Collateral.

(d) Utility's revenues will be used first to pay the current operating costs and maintenance of the water system, then to pay dividends to the City to enable it to pay the debt service with respect to the Bonds and any other debt issued to expand and improve the water system. All instruments issued to improve or

expand the water system will be payable from Utility's revenues, underwritings by developers, or special assessments against property within the area serviced by Utility. All of Utility's costs of operating and maintaining its business will be fully funded from its revenue, and neither the City nor any other governmental entity will provide any funds for the reasonably foreseeable operation, maintenance, capital, or other expenditures of Utility.

(e) The City reasonably expects that neither it nor any other governmental entity will within five years after the acquisition of Utility by the City provide any Financial Support to Utility.

(f) The City through its sole ownership of Utility and control of Utility's management intends to establish the rates charged by Utility for its public water service at a level sufficient to pay dividends in amounts sufficient to enable the City to pay the debt service on the Bonds, the costs of operating and maintaining Utility's assets, and capital expenditures and to maintain working capital and other reserves consistent with the needs of Utility's public water service.

For purposes of the foregoing representations:

(i) Financial Support includes any direct or indirect payment or other financial contribution or commitment to or on behalf of the Utility, whether in the form of cash, property, services, guarantees, assumptions, or otherwise.

(ii) Financial Support does not include any goods or services for which the Utility pays reasonable consideration, including, without limitation, purchases from the City for which the Utility pays reasonable consideration.

(iii) Financial Support does not include economic incentives or subsidies provided by City, State, or any political subdivision thereof directly to individuals or entities that are connecting or connected to the Utility, provided that any such amounts paid over to Utility are for connection charges and not to benefit the Utility as a whole.

LAW AND ANALYSIS

Section 115(1) 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.

Generally, if income is earned by an enterprise that is an integral part of a state or 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; § 511(a)(2)(B); Rev. Rul. 71-131, 1971-1 C.B. 28. When a state or political subdivision conducts an enterprise through a separate entity (i.e., an entity that is not considered an integral part of the state or political subdivision), however, the income of the entity may be exempt or excluded from income under a specific provision such as § 501 or § 115.

In Maryland Savings-Share Ins. Corp. v. United States, 308 F. Supp. 761 (D. Md. 1970), rev'd on other grounds, 400 U.S. 4 (1970) ("MSSIC"), 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 § 115 issues.

In Michigan 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 § 11(a). 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, 1957-1 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from the 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.

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

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.

Section 301.7701-2(a) provides:

> For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-2(b) provides, in part:

> For federal tax purposes, the term corporation means--
> (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
>
> (2) An association (as determined under § 301.7701-3);
>
> ***
>
> (6) A business entity wholly owned by a State or any political subdivision thereof. . .

If Utility is determined to be an integral part of the State or the City as a result of the transactions described above,

§ 115 will not apply to the income of Utility. The first factor in determining Utility's status following the acquisition by the City is whether there is or will be a substantial financial commitment to Utility by the State or a political subdivision of the State.

For Utility to be considered an integral part of the State or of a political subdivision of the State, Utility must receive a substantial financial commitment from the State, either directly or through a political subdivision thereof. The acquisition of Utility will be financed with the Bonds, which will be without recourse to the general assets of the City and secured only by a pledge of, and payable from, the Collateral. Further, the City represents that it reasonably expects that neither it nor any other governmental entity will within five years after the acquisition of Utility by the City provide any financial support to Utility. Any additional debt instruments issued to improve or expand the water system will be payable from Utility's revenues, underwritings by developers, or special assessments against property within the area serviced by Utility. All of Utility's costs of operating and maintaining its business will be fully funded from its revenue and neither the City nor any other governmental entity will provide any funds for the reasonably foreseeable operation, maintenance, capital, or other expenditures of Utility.

Accordingly, after considering the cumulative financial contributions that the City and State have made or intend to make to Utility, Utility has not received and will not receive a substantial financial commitment from the State or a political subdivision thereof. Therefore, Utility will not meet the financial commitment requirement of the integral part test.

Because we have determined that there is no substantial financial commitment from the State or a political subdivision thereof, we do not address whether Utility would meet the state control factor for integral part status.

Having concluded that Utility is not an integral part of the State or any political subdivision, we now look to the factors (to determine whether its income may be excludable from gross income) under § 115(1).

Rev. Rul. 57-151, 1957-1 C.B. 64, concludes that the income earned by a trust created to provide utility services such as water supply, fire protection, and sewage disposal was not subject to federal income tax. No funds of the trust could be diverted to any private use and, upon termination of the trust,

after payment of all debts and obligations, the remainder of the trust assets would be distributed to the board of county commissioners.

The term "political subdivision" is not defined in the Code. However, the interpretation of "political subdivision" contained in § 1.103-1(b) of the Income Tax Regulations for purposes of § 103 has been used to define the term for purposes of other Code sections. Section 1.103-1(b) provides that the term "political subdivision" denotes any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. The three generally acknowledged sovereign powers are the power to tax, the power of eminent domain, and the police power. See Commissioner v. Estate of Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). It is not necessary that all three of these powers be delegated. However, possession of only an insubstantial amount of any or all sovereign powers is not sufficient. The City is a municipal corporation, and therefore constitutes a political subdivision for federal tax purposes.

Utility is similar to the trust described in Rev. Rul. 57-151. Utility provides water for residential, commercial, and industrial use as well as for fire protection and other municipal services in the City. Under the proposed articles of incorporation, no earnings or assets of Utility may inure to the benefit of any private person. Upon dissolution, after payment of all debts and obligations, all remaining assets will be distributed to the City, another political subdivision of the State, or other governmental entity specified by Utility's board of directors. Additionally, Utility is under the control of the City, a political subdivision of the State. Therefore, we conclude that Utility is a public utility for purposes of § 115(1) and the income derived from the water utility service operations and activities of Utility following the conversion will accrue to a political subdivision of the State. Accordingly, that income will be excludable from gross income under § 115(1).

We note that §§ 6012(a)(2) and 1.6012-2(a)(1) provide, in general, that every corporation, as defined in § 7701(a)(3), subject to taxation under subtitle A is required to file an income tax return regardless of whether it has taxable income and regardless of its gross income. Accordingly, Utility will be required to continue to file income tax returns pursuant to § 6012(a)(2).

This ruling presumes that 100% of the ownership of Utility will be held by the City. If Utility issues additional stock, it must be held by the City, the State, a political subdivision of the State, or an entity that itself qualifies to exclude income from gross income under § 115. In addition, only the City, the State, a political subdivision of the State, or an entity that itself qualifies to exclude income from gross income under § 115 may receive a transfer of any portion of the ownership of Utility.

If the facts and circumstances in the future are other than as contemplated by the foregoing representations (e.g., the nature of incentives offered or sponsored by the State or political subdivisions thereof differs materially in kind or extent from prior incentives), the City and Utility should seek an appropriate supplemental ruling from the Internal Revenue Service with respect to the presence or absence of financial support for Utility and the effect thereof on the status of Utility (and the original ruling).

No opinion is expressed about the following issues:

1. The tax treatment of the proposed transaction under other provisions of the Code and Regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.
2. The tax treatment of future actual or constructive dispositions of assets by Utility, including the application of § 1245 or § 1250.
3. Whether income from the sale or other disposition after the City's acquisition of Utility of property that was held by Utility prior to the City's acquisition of Utility is excluded under § 115.
4. Whether interest on debt incurred by the City to purchase Utility is excludable under § 103(a).

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

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

In accordance with the powers of attorney on file in this office, copies of this letter are being sent to your authorized representatives.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and Products)

By: _____
Alice M. Bennett
Chief, Branch 3

enclosures: Copy of this letter
Copy for section 6110 purposes