Internal Revenue Service

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Department of the Treasury

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Person to Contact:

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Date:
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LEGEND:

Taxpayer 1 =

Taxpayer 2 =

Taxpayer 3 =

Federal Court =

State 2 =

Year 1 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =

a =
b =
c =
d =

This is in response to a letter dated January 9, 1998, and subsequent correspondence requesting rulings concerning the federal tax status of Taxpayers 1 through 3. Specifically, you requested rulings that the income earned by Taxpayer 3 on the money in the accounts for Taxpayer 1 and Taxpayer 2 prior to distribution to Taxpayers 1 and 2 is income excluded from gross income under § 115 of the Internal Revenue Code.

29

FACTS

In Year 1, a class action suit was filed against a group of companies, entities, and individuals (the defendants) that are involved in the insurance industry, charging the defendants with violations of federal and state antitrust and other laws. The class was broken into two subclasses: Participating States and Private Plaintiffs. The Participating States class was made up of governmental entities within a specific states (Participating States). The Private Plaintiffs class was made up of numerous private individuals and governmental entities in non-Participating States.

On Date 1, the classes and the defendants entered into a settlement agreement which was approved by the Federal Court. The settlement agreement provided for, in part, the establishment of Taxpayer 1 and Taxpayer 2. Also, the settlement agreement provided that the defendants would pay $ b to settle their liabilities under the class action suit. On Date 2, the defendants paid $ b to Taxpayer 3 to be held and invested until distributed to the ultimate recipients. At the time of the payment to Taxpayer 3, the $ b was divided into five distinct accounts, each of which was accounted for separately. The income earned on the money in each account was recorded separately.

Two of the accounts were for Taxpayers 1 and 2. Taxpayer 1's account contained $ c, and Taxpayer 2's account contained $ d. The remaining three accounts were for the counsel involved in the class action.

Taxpayer 1

On Date 3, Taxpayer 1 was incorporated as a non-profit corporation under the laws of State 2. Taxpayer 1 received a ruling from the Internal Revenue Service on Date 4 that it qualifies as a § 503(c)(3) organization.

Taxpayer 1's account was distributed to Taxpayer 1 on Date 5. Taxpayer 1 was organized to assist governmental entities, particularly self-insured governmental entities, by providing for the collection, compilation, analysis, and dissemination of data affecting risk management. The information will assist governmental entities in their attempts to track and better control tort liability, workers compensation liability, and other risks related to the performance of public services. In particular, Taxpayer 1 will collect information about various types of governmental entities, such as cities, counties, school districts, transit systems, water districts, and other specific special governmental districts. Taxpayer 1 will provide the information to municipalities and other local government entities.

Taxpayer 1 intends to make this type of information available to governmental entities on a permanent basis by creating a database facility or operation that will be self-supporting. Taxpayer 1 will also be involved in research, educational, and other programs that will provide risk management and assessment assistance to governmental entities.

All seven members of the initial Board of Directors for Taxpayer 1 were appointed by the Attorneys General of the Participating States. Each member is either a public official or a representative of an association which exclusively represents public officials. Under Taxpayer 1's By-laws, each director is required to act on behalf of the Attorneys General of the Participating States. A director may be removed without cause if at least two-thirds of the directors vote for removal.

In the event that Taxpayer 1 is dissolved, Taxpayer 1's Articles of Incorporation provide that any remaining monies will be distributed to similar charities or for educational purposes described in the settlement agreement. Taxpayer 1 intends to revise its Articles of Incorporation and its By-Laws to provide that any funds remaining upon dissolution will be distributed to Taxpayer 2.

Taxpayer 2

Taxpayer 2 was incorporated on Date 6 as a non-profit corporation under the laws of State 2. Taxpayer 2 received a ruling from the Internal Revenue Service on Date 7 that it qualifies as a § 503(c)(3) organization. Taxpayer 3 administered the monies paid under the settlement agreement between Date 2 and Date 8.

Taxpayer 2 was established to provide high quality training, education, and technical services related to various types of insurance. Taxpayer 2 will provide these services to policyholders, self-insured entities, and governmental insurance pools. Taxpayer 2 is to serve as a resource for practical enhancement of risk management for both public entities and the general public.

Taxpayer 2 will focus primarily on the risk management needs of governmental entities, but will also provide educational or other services to the general public; Taxpayer 2 will not provide services tailored to individual private persons or businesses.

Taxpayer 2 will be governed by a five-member Board of Directors. Three of the directors will be representatives from the public sector; currently, these directors are representatives of governmental entities who were part of the class action law suit.

296

Upon dissolution of Taxpayer 2, any remaining assets will be held in escrow by the Attorneys General of the Participating States, their appointees, or an appointee of the Federal Court. Taxpayer 2's Articles of Incorporation currently provide that the Attorneys General may use the assets to relieve the burdens of the Participating States within the meaning of § 501(c)(3) of the Code. Taxpayer 2 intends to amend its Articles of Incorporation to provide that the assets may only be used to relieve the burdens of the Participating States, through distribution to the Participating States, integral parts or political subdivisions of the Participating States, or entities that themselves qualify to exclude income from gross income under § 115.

LAW AND ANALYSIS

Section 115(1) of the Code excludes from gross income any income derived from the exercise of an essential governmental function and accruing to a State or political subdivision thereof.

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, 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 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. 90-74 illustrates that § 115 does not apply to an entity's income if there is more than an incidental private benefit connected with the income.

Rev. Rul. 77-261, 1977-2 C.B. 45, addresses the treatment of income from a fund for the temporary investment of cash balances of a state and its political subdivisions. The fund was authorized by state statute, managed by the state treasurer, and benefitted only the state and its political subdivisions. The ruling reasons that the investment of positive cash balances by a state or a political subdivision thereof 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. Rev. Rul. 77-261 holds that the

income of a fund, established under a written declaration of trust to pool the temporary investments of the state and its political subdivisions, is excludable from gross income under § 115(1) of the Code. The ruling further notes that the determination of whether a function is an essential governmental function depends on the facts and circumstances of each case. Additionally, the ruling concludes that § 115(1) does not require that the income in question accrue only to a single state, a single political subdivision, or a single governmental entity.

It has been represented that Taxpayer 3 is a qualified settlement fund (QSF) under § 1.468B-1(c) of the Income Tax Regulations, and accordingly, we express no opinion on this matter. Assuming that Taxpayer 3 qualifies as a QSF, Taxpayer 3 is a separate taxable entity, the income of which may be excluded from gross income under § 115 of the Code if the provisions of that section are satisfied.

Under § 115 of the Code, income is excluded from gross income if it is derived from the exercise of any essential governmental function and accrues to a state or any political subdivision of a state. The determination whether a function is an essential governmental function depends on the facts and circumstances of each case.

Taxpayers 1 and 2 are involved in activities that are intended to assist governmental entities and the general public by providing statistical information and analyses that will help the recipients to better manage and control risk. This is similar to the activities undertaken in Rev. Rul 90-74, where governmental entities banded together to form an insurance pool, in part to help them better manage risk. Thus, Taxpayers 1 and 2 perform an essential governmental function.

In addition to the performance of an essential governmental function, to qualify to exclude income from gross income under § 115, the income of an entity must also accrue to a state or political subdivision of a state. Further, as is described in Rev. Rul. 90-74, § 115 does not apply to an entity's income if there is more than an incidental private benefit connected with the income.

Taxpayer 1 will provide services only to governmental entities. Thus, all of Taxpayer 1's income is used to provide services to governmental entities. Upon dissolution, Taxpayer 1's assets will be distributed to Taxpayer 2. Thus, if Taxpayer 2 qualifies to exclude income from gross income under § 115, Taxpayer 1 will also qualify to exclude income from gross income under § 115.

Taxpayer 2 will provide educational, training, and other services related to risk management to governmental entities and the general public. Taxpayer 2 intends to focus much of its

efforts on assisting governmental entities, but will use the information and programs developed as part of its assistance to governmental entities to assist the general public as well. Taxpayer 2 will not develop programs nor provide services tailored to specific private parties. In the event of dissolution, Taxpayer 2's assets will be distributed to the Attorneys General for the Participating States to be used to reduce the burdens of government of those states. The assets may only be distributed to the Participating States, integral parts or political subdivisions of the Participating States, or entities that themselves qualify to exclude income from gross income under § 115.

Based upon the information provided, the income of Taxpayer 2 will accrue to a state or political subdivision of a state. To the extent that entities or persons other than governmental entities will receive benefits from Taxpayer 2, these benefits are not more than incidental. We therefore conclude that Taxpayer 2 may exclude income from gross income under § 115. Because Taxpayer 2 may exclude income from gross income under § 115, Taxpayer 1 may also exclude income from gross income under § 115.

Because both Taxpayer 1 and Taxpayer 2 may exclude income from gross income under § 115, the income attributable to the segregated accounts for Taxpayers 1 and 2 accrues only to the Participating States and governmental entities of the Participating States, similar to the income of the fund in Rev. Rul. 77-261 and the organization in Rev. Rul. 90-74. Therefore, the income earned by Taxpayer 3 that is allocated to the separate accounts for Taxpayers 1 and 2 is excluded from gross income under § 115 of the Code.

CONCLUSION

Based on the information and representations submitted by Taxpayers 1, 2, and 3, we hold as follows:

1. Taxpayer 1 and Taxpayer 2 qualify to exclude income from gross income under § 115.

2. The income earned by Taxpayer 3 that was allocated to the accounts for Taxpayer 1 and Taxpayer 2 is not included in gross income under § 115.

The above holdings are conditional pending amendment to the Articles of Incorporation and By Laws of Taxpayers 1 and 2 that upon dissolution of Taxpayer 1, all of its remaining assets will be distributed to Taxpayer 2, and upon dissolution of Taxpayer 2, any remaining assets may only be distributed to the Participating States, integral parts or political subdivisions of the Participating States, or entities that themselves qualify to exclude income from gross income under § 115.

29

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

Except as specifically set forth above, no opinion is expressed regarding the federal tax consequences of the transactions described above under any other provisions of the Code or Regulations. In particular, no ruling is expressed as to whether Taxpayer 3 is a QSF and no ruling is provided concerning the determination of Taxpayer 3's modified gross income if Taxpayer 3 is a QSF.

A copy of this letter should be attached to the next income tax returns filed for Taxpayers 1, 2, and 3.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and
Products)

By: _____
Alice M. Bennett
Chief, Branch 3

enclosures:

copy of this letter
section 6110 copy