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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

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Date:
September 27, 1999

LEGEND:

City =
State =
Authority =
Agency =
Commission =
City Council =

Ordinance 1 =

Ordinance 2 =

State Law 1 =

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

A =
B =

x =
y =

Dear :

This is in response to a letter dated February 12, 1999, requesting a ruling that Authority is exempt from federal income tax because it is an integral part of a political subdivision of the State or that the income of Authority is excluded from gross

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income under section 115 of the Internal Revenue Code (the "Code").

FACTS

State law provides for the existence, in each community, of a public body, corporate and politic known as a redevelopment agency. A "community" is defined as a city, county, city and county, or Indian tribe, band, or group which is incorporated or which otherwise exercises some local governmental powers. State law allows the legislative body to declare that there is a need for a redevelopment agency to function in the community and to declare itself to be the agency (subject to certain procedural requirements), provided that in the ordinance declaring itself to be the redevelopment agency, the legislative body makes a finding that the action shall serve the public interest and promote the public safety and welfare in an effective manner.

State law provides that a legislative body, which has declared itself to be the redevelopment agency for a community, may by ordinance create a community redevelopment commission. According to State statute, the commission's purpose is to provide the community with the option of operating and governing its redevelopment agency, or its redevelopment agency and its housing authority, under a single operating entity and board. State law also allows the legislative body of a community to declare itself to be the commission by ordinance and to create a community development committee (subject to certain restrictions), which will review and make recommendations on all matters to come before the commission.

On Date 1, the City Council, pursuant to Ordinance 1, recognized a need for a redevelopment agency and declared itself to be the Agency. In Ordinance 1, the City Council recognized the need for a redevelopment agency because of the existence, within the City, of areas which constituted either social or economic liabilities, or both, requiring development or redevelopment in the interest of the health, safety, and general welfare of the people of the City.

On Date 2, the City Council adopted Ordinance 2, in which it recognized a need for a commission to function with respect to both the redevelopment agency and the housing authority and declared itself to be the Commission.

On Date 3, Authority was organized as a non-profit public benefit corporation under the laws of State Law 1. Authority was formed specifically under the authority and control of the Commission. Under its articles of incorporation, as amended, the

nature of Authority's business and purposes are described as follows -

(1) To acquire the leasehold interest in certain parcels of real property in the City, together with all easements appurtenant thereto (the "Property").

(2) To own, hold, sell, assign, transfer, operate, lease, mortgage, pledge, and otherwise deal with the Property.

(3) To exercise all powers enumerated in the corporate code of the State that are necessary or convenient to the conduct, promotion, or attainment of the business or purposes otherwise set forth in the articles of incorporation.

(4) To receive gifts, donations, bequests, and devises of all kinds and descriptions which are in the form of cash or are readily convertible into cash, and perform any and all related legal acts necessary or advisable to advance Authority's purposes as set forth above in (1), (2), and (3), and to apply the principal and interest of such gifts, donations, bequests, and devises as may be directed by the donor consistent with the purposes set forth above in (1), (2), and (3), or as the board of directors of Authority may determine in the absence of the donor's direction, provided that it is consistent with the purposes set forth above in (1), (2), and (3).

(5) To enter into contracts, and perform any other acts within or without the State, which may be necessary or expedient in furtherance of the purposes for which Authority is formed.

In addition, the articles of incorporation limit Authority's activities as follows: (i) Authority may only incur indebtedness in an amount necessary to acquire, operate, and maintain the Property; (ii) Authority shall not incur, assume, or guaranty any other indebtedness so long as any mortgage lien exists on the Property; (iii) Authority may not consolidate or merge with or into any other entity unless certain requirements are met; (iv) Authority shall not voluntarily commence a case with respect to itself, as debtor, under the federal bankruptcy code or any similar federal or state statute without unanimous consent of the board of directors so long as a mortgage lien exists on the Property; and, (v) no material amendment to the articles of incorporation or bylaws of Authority may be made without approval of the mortgagee holding a first lien on the Property.

The articles further state that no part of the net income or assets of Authority shall inure to the benefit of any private person. The Authority represents that, as soon as is practical,

it will amend its articles of incorporation to provide that the property of the Authority is irrevocably dedicated to civic purposes for the betterment of the City and, upon the liquidation, dissolution or abandonment of the Authority, the assets thereof will not inure to the benefit of any private person, officer, or director of the Authority, but shall be distributed to the City to be used for such purposes.

Authority's bylaws, as amended, provide that Authority shall have no members. In addition, the bylaws restrict, to no more than x-percent, the percentage of interested persons that may serve on the board of directors. An "interested person" means either (i) any person currently being compensated by Authority for services rendered within the previous twelve months, excluding any reasonable compensation paid to a director as a director, and (ii) any employee, contractor, or agent of any lender or other party holding a security interest in real property owned, leased, or controlled by Authority.

Authority represents that, as soon as practical, it will amend its bylaws to provide that a majority of the members of its board of directors must be appointed by the City. As of Date 7, the board of directors consisted of five directors, including the mayor of the City, the mayor pro tem, and three City Council members. In addition, as of that Date, there were three elected officers, including the City's administrator and executive director of community development (President), the City's community development director (Secretary), and the City's finance director (Treasurer). Because Authority has no members, all directors are elected annually by the board.

The City must approve Authority's annual budget. The balance sheet for Authority dated as of year end, Date 6, shows total net assets of $A. The City made a gross contribution to Authority in the amount of $B as shown on Authority's financial statement covering Date 4 through Date 5. This contribution represents approximately y-percent of total revenues for the first year and accounts for nearly all of the net worth of Authority.

Finally, Authority represents that it has no employees of its own, but instead the City provides its own employees to Authority for its use on an "as needed" basis without charge. Authority represents that it makes no payments to the City's employees for services provided to the Authority or on its behalf by such employees and Authority does not reimburse the City for the use of the City's employees.

LAW

Section 115(1) of the Code provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or any political subdivision of a state.

Section 115 of the Code applies to entities that are separate from a state or its municipalities, that is, organizations that are not integral parts of the government of a state or a political subdivision. Section 115 does not apply to the states or their political subdivisions, such as counties, cities, or towns.

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

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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);

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(6) A business entity wholly owned by a State or any political subdivision thereof. . .

ANALYSIS AND HOLDING

In this case, the City exercises control over Authority. The City created the Commission by ordinance, which formed Authority as a non-profit public benefit corporation. The board of directors currently consists of five directors, namely, the mayor of the City, the mayor pro tem, and three City Council members. In addition, the three elected officers of Authority are employees of the City. Authority's bylaws will be amended to provide that a majority of the members of the board of directors must be appointed by the City. Further, Authority has no members and has no capital stock or shares.

Furthermore, the City must approve Authority's annual budget. The City controls Authority's fiscal management and day-to-day activities, including approval of its budget. Authority is considered a component unit of the City's financial reporting entity, and Authority's financial results are consolidated into the City's financial statements.

Authority has no employees, but rather the City provides its employees for use by Authority on an "as needed" basis. Authority does not reimburse the City or pay any of the employees for the services rendered by City employees to Authority or on its behalf.

In addition, the City contributed $B to Authority in its first year of operation, which represented approximately y-percent of its total revenues for the Authority's first fiscal year. The contribution was provided to assist Authority in its day-to-day operations and was not restricted except that the funds were to be used solely in furtherance of Authority's mission of civic betterment for the City. The funds were not intended to be used to pay down any other debt obligations owed to the City, and Authority has no obligation to repay the funds to the City. Nearly all the net worth of Authority is attributable to the contribution made by the City.

Accordingly, after considering the financial contribution that the City has made and the degree of control exercised by the City, and provided that the Authority's bylaws and articles of incorporation are amended as described in this letter, we conclude that Authority is an integral part of the City, which is a political subdivision of the State. Because we have determined that Authority is an integral part of the City, we need not address whether Authority's income is excludable from gross income under § 115(1).

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

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
Alice M. Bennett
Chief, Branch 3

enclosures:
Copy of this letter
Copy for section 6110 purposes