

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

02/20/2002

New Fund =
Department =
Fund A =
Fund B =
State =
State Treasurer =
Type A1 insurance coverage =
Type A2 insurance coverage =
Type B coverage =
C =
a/c/dd =
aaa =
bbb =

Dear

This letter is in response to your letter dated October 26, 2001, requesting the following rulings:

(1) New Fund, if established in accordance with the proposed legislation you have attached, will constitute an integral part of the State and, therefore, its income will be exempt from federal income taxation.

(2) The debt obligations issued by New Fund will constitute obligations of a state or political subdivision thereof within the meaning of section 103 of the Internal Revenue Code.

FACTS AND REPRESENTATIONS

The Department is a political subdivision of the State.

Fund A was created by the State Legislature as a response to the collapse of the property insurance market in the State in the aftermath of certain unprecedented natural disaster losses. The level of insured losses led many insurance companies to seek to withdraw from the State, while other companies simply elected to non-renew existing property insurance policies. As a result, Fund A was created to fill a void in the property insurance market and to serve as the insurer of last resort to augment the

private insurance market. As statutory successor to Fund A, New Fund will continue to provide Type A1 and Type A2 insurance for applicants who are unable to procure insurance in the private insurance market.

Fund B's purpose is to provide State residents Type B coverage, when it is not available on the private insurance market; and pay insureds' claims when losses occur. Under the proposed legislation, Fund B's policies will be transferred on a/c/dd to New Fund and shall become New Fund's policies. Under the proposed legislation, New Fund and authorized insurers will also enter into C agreements for Type B coverage where New Fund and an authorized insurer are each solely responsible for a specified percentage of coverage of an eligible risk as set forth in a C agreement.

Under the proposed legislation, New Fund will be a corporation overseen by a multi-member board of governors from diverse geographical areas of the State. The governors shall be appointed by the State Treasurer for three-year terms and serve at the pleasure of the State Treasurer. The State Treasurer shall designate one of the appointees to be chair. Any board vacancy shall be filled by the State Treasurer for the unexpired term of such board member. The State Treasurer shall appoint a technical advisory group to provide information and advice to the board of governors in connection with the board's duties. The State Treasurer will also engage the executive director and senior manager of New Fund who also serve at the pleasure of the State Treasurer. The executive director will be responsible for employing New Fund's employees, subject to review and approval by the Office of the State Treasurer.

New Fund will operate pursuant to a plan of operation approved by the Department, and will be subject to the Department's continuous review. The Department may, by order, withdraw all or part of a plan if the Department determines that conditions have changed since approval was granted and that the purposes of the plan require changes in the plan. New Fund will file with the Department quarterly statements of financial condition, an annual statement of financial condition and audited financial statements. New Fund will also report monthly to the Department on the types, premium, exposure and distribution by county of its policies in force, and submit other reports required by the Department to carry out its oversight.

Meetings of New Fund's board of governors and the board committees, unless specifically exempted by law, will be required by the proposed legislation to be held in public, and subject to the State aaa Law. The records of New Fund, unless specifically exempted by law, will be public records and open to the public for inspection and copying in accordance with bbb, State Statutes.

All revenues, assets, liabilities, losses and expenses of New Fund will be divided into three accounts covering Type A1 policies, Type A2 policies and Type B policies. Separate accounts will be maintained as long as certain financial obligations of Fund A and Fund B are outstanding. Afterward, New Fund may utilize a single account for all revenues, assets, liabilities, losses and expenses of New Fund. Revenues, assets, liabilities, losses and expenses not attributable to a particular account shall be prorated among the accounts.

New Fund will set rates for Type A1 policies, which will be no less than the highest average rate of the top 20 insurers within a given county. Rates for Type B policies

shall be actuarially sound and not competitive with approved rates charged by authorized insurers. New Fund will make a rate filing at least once a year, but no more often than quarterly.

All insurers authorized to write subject lines of businesses in the State and all surplus lines insureds procuring subject lines of business in the State, will be subject to assessment to fund deficits incurred by New Fund. When New Fund experiences a deficit in a plan year that is not greater than 10% of the aggregate statewide direct written premium for the subject lines of business for the prior calendar year, the entire deficit is collected through regular assessments ("Regular Assessments") of authorized insurers and surplus lines insureds, after verification by the Department. When New Fund experiences a plan year deficit greater than 10% of the aggregate statewide written premium for the subject lines of business for the prior calendar year, the amount in excess of 10% is collected through emergency assessments ("Emergency Assessments"), after verification by the Department. Each insurer who is assessed may recoup its portion of any Regular Assessment directly from its policyholders. None of the policyholders affected by Regular Assessments will be New Fund policyholders, and a large percentage of the policyholders affected by Emergency Assessments will not be New Fund policyholders.

If New Fund imposes Regular Assessments to fund a New Fund deficit, the proposed legislation requires imposing a market equalization surcharge ("Market Equalization Surcharge") on New Fund policyholders. This provision generates additional revenue for New Fund and provides additional financial strength. These surcharges are in addition to any amounts necessary to fund the deficits of New Fund.

The proposed legislation also requires New Fund to certify to the Department its needs for annual assessments as to any particular calendar year and for any interim assessments deemed necessary to sustain operations as to a particular year.

For purposes of the State Corporate Income Tax, New Fund will be treated as a political subdivision and exempt from tax. The proposed legislation provides that New Fund's premiums, assessments, investment income and other revenues will be funds received for providing insurance coverage, paying claims, securing and repaying debt obligations and will not be considered taxes, fees licenses or charges for services imposed by the legislature on individuals, business or agencies outside of State government. The proposed legislation states the legislature intends that the tax exemptions provided New Fund will better enable New Fund to fulfill its public purposes. The proposed legislation also requires New Fund to impose, collect and retain the amount equal to the premium tax to augment its financial resources.

New Fund may dissolve upon the Department's approval that the conditions giving rise to its establishment no longer exist. Upon dissolution, all assets remaining after paying of the obligations will become property of the State.

Law

Issue 1

In general, if income is earned by an enterprise that is an integral part of a state or a 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; Section 511(a)(2)(B) of the Code; GCM 14407, C.B. XIV-1, 103 (1935), superseded by Rev. Rul. 71-131, 1971-1 C.B. 28. When a state conducts an enterprise through a separate entity, however, the income of the entity may be excluded from gross income under section 115.

In Maryland Savings-Share Insurance Corp. ("MSSIC") v. United States, 308 F. Supp. 761, rev'd on other grounds, 400 U.S. 4 (1970), 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. Although the district court was reversed on other grounds, the Supreme Court agreed with the lower court's analysis of the instrumentality and section 115 issues. The Supreme Court rejected MSSIC's position that "it is an instrumentality of the State and hence entitled to exemption from federal taxation under the doctrine of intergovernmental immunity and under section 115 of the Code." MSSIC, 400 U.S. at 7, n.2.

In State of Michigan and Michigan Education Trust 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 section 11(a) of the Code. 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 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from a 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 a state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to 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 separate from a state or political subdivision 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 section 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 section 301.7701-3) that is not properly classified as a trust under section 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 section 301.7701-3);

* * *

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

Thus, the check-the-box regulations indicate that even if New Fund were classified as a separate entity from the Department, it nevertheless could be treated as an integral part of the Department if New Fund so qualifies.

New Fund, under the proposed legislation, will be created for the public purpose of insuring the existence of an orderly market of Types A1 and A2 insurance, as well as Type B insurance, for State residents and businesses.

Under the proposed legislation, New Fund will be supervised and controlled by State Treasurer who will appoint all of the members of the board of governors, and its executive director and general manager, all of whom will serve at the State Treasurer's pleasure. The proposed legislation also explicitly provides that the executive director will employ New Fund's employees subject to review and approval by the Office of State Treasurer. New Fund operations are subject under the statute to continuous review and supervision by the Department. New Fund must receive approval for its Plan of Operation from the Department, and must file regular financial reports. The rates New Fund will be allowed to charge are specified in the proposed legislation and the circumstances under which assessments to cover deficits can be made will be subject to verification by the Department. All of New Fund's activities, and its employees, will be subject to the supervision and control of the State Treasurer.

Under the proposed legislation, New Fund will also collect an amount equal to the premium tax and will retain such amount to augment its resources. Accordingly, the State will provide a substantial financial commitment under the proposed legislation.

Accordingly, we have determined that if the proposed legislation is enacted, and New Fund operates consistently with the legislation, then New Fund will constitute an integral part of the Department, a political subdivision of the State, and its income will be exempt from federal income tax.

Issue 2

I.R.C. § 103(a) provides that except as provided in subsection(b), gross income does not include interest on any State or local bond.

I.R.C. § 103(c)(1) provides that the term “State or local bond” means an obligation of a State or political subdivision thereof.

Treas. Reg. § 1.103-1 provides in pertinent part that obligations issued by or on behalf of any State or local government unit by constituted authorities empowered to issue such obligations are the obligations of such unit. For purposes of this section, the term “political subdivision” denotes any division of any State or Local Government unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

We have already determined that if the proposed legislation is enacted, and New Fund operates consistently with the proposed legislation, that New Fund will be an integral part of the Department, a political subdivision of the State. Obligations issued by New Fund will thus be obligations issued by or on behalf of the Department, and will constitute obligations of a state or political subdivision within the meaning of section 103 of the Internal Revenue Code.

We are not ruling as to whether the interest of any specific obligation that may be issued by New Fund will be exempt from taxation.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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

cc: