

UCLA

UCLA Public Law & Legal Theory Series

Title

The Integral, the Essential and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates

Permalink

<https://escholarship.org/uc/item/0st3545n>

Journal

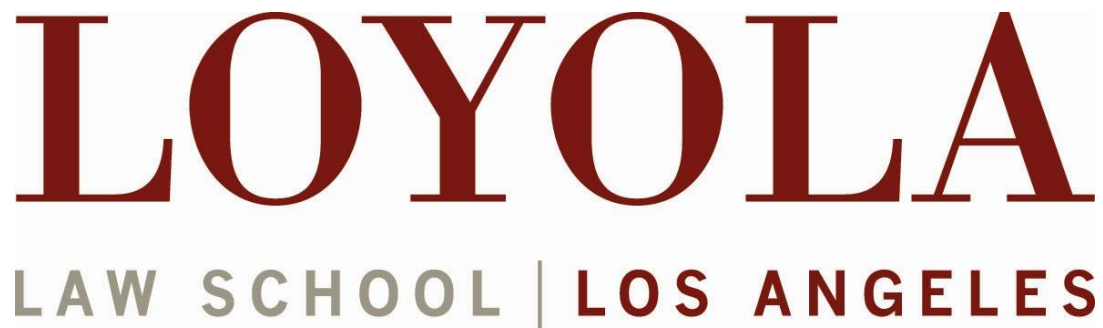
Journal of Corporation Law, 23

Author

Aprill, Ellen P

Publication Date

1998



Legal Studies Paper No. 2006-23
August 2006 (1998)

**The Integral, the Essential and the
Instrumental: Federal Income Tax
Treatment of Governmental Affiliates**

Professor Ellen P. Aprill

The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates

Ellen P. Aprill*

I. INTRODUCTION	803
II. REGULATORY FRAMEWORK	806
A. <i>Status as Political Subdivision</i>	807
B. <i>Integral Parts</i>	810
C. <i>Section 115 Entities</i>	814
D. <i>Instrumentalities</i>	819
III. CASE STUDIES	823
A. <i>Michigan Education Trust</i>	824
B. <i>State Disaster Funds</i>	828
C. <i>State Workers' Compensation Act Companies</i>	833
IV. RECOMMENDATIONS	835

I. INTRODUCTION

A variety of entities enjoy exemption from federal taxation. Section 501(c) of the Internal Revenue Code, for example, exempts not only charitable, educational, religious, and scientific organizations under subsection 501(c)(3), but more than twenty additional categories covering such varied entities as labor unions, social clubs, and even cemeteries.¹ Yet no provision of the Internal Revenue Code explicitly exempts states and their political subdivisions from federal income taxation. In our federalist system, “an indestructible Union, composed of indestructible States,”² we would expect these governmental entities to be exempted from federal income tax, and the Internal Revenue Service (IRS) shares these expectations. The IRS has concluded that states and their political subdivisions—which the IRS defines as entities with the sovereign powers of taxation, eminent domain, and police power³—are free from federal income tax under an implied

* Professor of Law, Loyola Law School. B.A., University of Michigan, 1970; M.A., UCLA, 1972; J.D., Georgetown University Law Center, 1980. The author would like to thank Catherine Fisk for comments on an earlier draft. Bettina Suessman and Mai Phuong Bui provided valuable research assistance.

1. See I.R.C. § 501(c)(5) (1997) (labor unions); I.R.C. § 501(c)(7) (1997) (social clubs); I.R.C. § 501(c)(13) (1997) (cemeteries).

2. *Texas v. White*, 74 U.S. (7 Wall.) 700, 725 (1868) (holding that when “Texas became one of the United States, she entered into an indissoluble relation” with other states in the Union).

3. See *infra* Part II.A.

statutory immunity.⁴ That is, states and their political subsidiaries are exempt because no provision of the Internal Revenue Code taxes them as such.

States and their political subdivisions, however, are not the only governmental organizations that qualify for exemption. According to the IRS, if an organization or enterprise can qualify as an integral part of a state or political subdivision, it is also exempt on the basis of the implied statutory immunity.⁵ In addition, section 115, a relatively obscure provision of the Internal Revenue Code, excludes from federal tax "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia."⁶ As interpreted by the IRS, however, section 115 does not afford the basis for exempting states and their political subdivisions from federal income tax. The IRS instead has concluded that section 115 applies to the income of an entity separate from a state or its political subdivision.⁷ Thus, the income of certain enterprises affiliated with state or local governments (along with state and local governments themselves) is exempt from federal income tax, either as integral parts of a state or political subdivision or under section 115 (as "section 115 entities").

IRS rulings recognize the close relationship between integral parts and section 115 entities by testing particular entities first under one doctrine and then under the other.⁸ At the same time, the IRS applies very different tests to the two categories. For example, examination of corporate governance is key to analysis under the integral part doctrine, but plays no role in section 115 rulings. For analysis under the integral part doctrine, the IRS emphasizes the initial source of funds. In contrast, for section 115 it considers the destination of funds upon dissolution. Further, the IRS balances private and public benefits for entities seeking section 115 status, but not for those seeking status as integral parts.

For particular purposes, the IRS and the Internal Revenue Code also recognize "instrumentality" as a category of entities separate from, but affiliated with, state and local governments.⁹ Unlike section 115 entities, instrumentalities are not exempt from tax by virtue of their status, although they may qualify for exclusion of their income under section 115.¹⁰ Indeed, the tests for status as a section 115 entity and those for status as an instrumentality exhibit striking similarities.¹¹ Thus, rarely would an instrumentality fail to qualify as a section 115 entity.

Moreover, both instrumentalities and section 115 entities can qualify for exemption under various categories of section 501(c), including section 501(c)(3). Other entities affiliated with governments may also qualify for exempt status under section 501(c)(3). To do so, the governmental institution must be a separate entity and a clear counterpart of a

4. See *infra* Part II.B.

5. See *infra* Part II.B.

6. I.R.C. § 115(1) (1997).

7. See Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421, 429-46 (1992) (discussing IRS interpretation of section 115).

8. See *infra* notes 64, 93-97 and accompanying text.

9. For example, municipal instrumentalities are exempt from certain payroll taxes under I.R.C. § 3121(b)(7) (1997) (FICA) and I.R.C. § 3306(c)(7) (1997) (FUTA), and employees of such instrumentalities are eligible for tax exempt employee annuities under I.R.C. § 403(b) (1997).

10. See *infra* notes 131-132 and accompanying text.

11. See *infra* notes 156-164 and accompanying text.

charitable, religious, or similar organization.¹² A government institution which is not a counterpart qualifies if it possesses sovereign powers and thus qualifies as a political subdivision.¹³

These five categories—political subdivision, integral part of a state or political subdivision, section 115 entity, instrumentality, and section 501(c) organization—form a complicated patchwork. A fire department, public library, hospital, or state college may fall into any one or several categories of this patchwork.¹⁴ Some of the categories overlap in both theory and in practice. A particular entity, for example, may simultaneously be a section 115 entity, an instrumentality, and a section 501(c)(3) organization, since the entity must be separate from a political subdivision and lack sovereign powers for all of these categories.

Other categories are distinct in theory, but overlap in practice. In theory, a particular entity cannot qualify as both an integral part of a political subdivision and a section 115 entity, since section 115 entities must be separate from any political subdivision. Yet, as discussed below, the tests applied by the IRS appear to give certain entities the choice of being treated as integral or separate.¹⁵ Similarly, in theory, a particular entity cannot qualify as both a political subdivision and a section 501(c)(3) organization, since the former must have sovereign powers and the latter must not. The IRS, however, permits certain kinds of entities to qualify either as political subdivisions or as organizations eligible for exemption under section 501(c)(3).¹⁶

Each classification has significant tax consequences. For example, reporting requirements and eligibility for charitable contribution deductions differ among these categories.¹⁷ More basically, political subdivisions and their integral parts are not subject to tax, whatever activities they undertake. Separate entities, even if affiliated with governments, are taxed unless they qualify under section 115 or section 501(c). As even the brief discussion above indicates, however, the rulings and cases in this area are inconsistent and difficult to reconcile.

12. See Rev. Rul. 74-15, 1974-1 C.B. 126; Rev. Rul. 60-384, 1960-2 C.B. 172; Rev. Rul. 55-319, 1955-1 C.B. 119.

13. See Rev. Rul. 74-15, 1974-1 C.B. 126; Rev. Rul. 60-384, 1960-2 C.B. 172; Rev. Rul. 55-319, 1955-1 C.B. 119.

14. See IRS, *IRS Exempt Organizations CPE Technical Instruction Program Textbook: Part II, Chapter F: State Institutions - Instrumentalities*, Tax Notes Today, Aug. 24, 1995, available in LEXIS, Fedtax Library, TNT File, 95 TNT 168-58; Rev. Rul. 67-290; 1967-2 C.B. 183 (hospital with limited powers of eminent domain qualifies for section 501(c)(3) status); Tech. Adv. Mem. 97-30-001 (July 25, 1997) (hospital as political subdivision); Priv. Ltr. Rul. 95-40-007 (Oct. 6, 1995) (hospital as section 115 entity); Priv. Ltr. Rul. 97-27-005 (July 3, 1997) (transplant group affiliated with medical school as instrumentality); Priv. Ltr. Rul. 97-16-026 (Apr. 18, 1997) (hospital as integral part of government).

15. See *infra* notes 75-78 and accompanying text.

16. See *infra* notes 54-57 and accompanying text.

17. Section 115 entities must file Form 1120. See Rev. Rul. 77-261, 1977-2 C.B. 45. Political subdivisions and their integral parts do not have to file form 1120. See Rev. Rul. 78-316, 1978-2 C.B. 104. Organizations exempt under section 501(c)(3) that also qualify as a state or political subdivision or as a section 115 entity are not required to file Form 990, the information return required of exempt organizations. Rev. Proc. 95-48, 1995-2 C.B. 418. Section 115 entities and instrumentalities are subject to the 20% limit on charitable contribution deductions (unless they qualify as exempt under section 501(c)(3)); whereas political subdivisions, integral parts, and section 501(c)(3) entities qualify for the 50% limit on charitable contribution deductions. Treas. Reg. § 1.170A-8 (1972).

In an earlier article, I argued that, in the case of section 115, Congressional action was necessary to end the confusion.¹⁸ This Article examines the tests for integral parts and for instrumentalities as well as those for section 115.¹⁹ In addition, the Article considers regulatory, judicial, and legislative developments since the publication of the earlier piece.²⁰ This broader view leads to a different conclusion, calling for action by the IRS rather than by Congress. This Article argues that the IRS could, and should, rationalize federal income tax treatment of governmental affiliates by promulgating regulations applicable to integral parts, section 115 entities, and instrumentalities.²¹ The long-standing tests for status as an instrumentality along with the newly-enacted statutory criteria for exemption of Workers' Compensation Act companies provide the model for the suggested regulations.

Part II of this Article discusses the current criteria for the various categories. Part III presents three cases studies: Michigan's pre-paid tuition plans,²² state disaster funds in California and Florida,²³ and state Workers' Compensation Act companies in Texas.²⁴ The Article concludes in Part IV by proposing regulations with the same substantive tests for all three categories of governmental affiliates—integral parts, section 115 entities, and instrumentalities. The Article urges that the regulations applicable to integral parts follow the model of recent regulations permitting treatment of business entities as separate from their owners for federal income tax purposes.²⁵ In other words, the Article recommends that the IRS formalize the current *de facto* rule and explicitly permit state and political subdivisions the choice of treating an organization as integral or separate.

II. THE REGULATORY FRAMEWORK

Because the Internal Revenue Code fails to address the income tax status of states, political subdivisions, and their affiliates, this area of tax law has developed largely through IRS interpretations. To determine whether an entity is a political subdivision, the IRS applies interpretive regulations promulgated under section 103 of the Internal Revenue Code.²⁶ For integral parts, section 115 entities, and instrumentalities, which are the focus of this Article, no applicable regulations exist.²⁷ The relevant interpretations for these categories take two main forms. Revenue rulings are official IRS interpretations published in the Internal Revenue Bulletin for the guidance of taxpayers.²⁸

18. See Aprill, *supra* note 7, at 496-502.

19. See *infra* Part II.

20. See *infra* Part III.

21. See *infra* Part IV.

22. See *infra* Part III.A.

23. See *infra* Part III.B.

24. See *infra* Part III.C.

25. See 26 C.F.R. § 301.7701 (1997).

26. See I.R.C. § 103 (1997) (addressing the treatment of interest on government bonds).

27. On the importance of regulations, see BORRIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 110.1 (2d ed. 1992) ("[R]egulations rank highest in the hierarchy of IRS rules because they can be issued by the Commissioner [of the Internal Revenue Service] only with the imprimatur of the Secretary [of the Treasury], and they are binding on the IRS as well as on taxpayers if they are not inconsistent with statutes.").

28. See *id.* at ¶ 110.5.3. Published rulings are reviewed both within the Internal Revenue Service and in the Office of Tax Policy at the Department of Treasury. Taxpayers may rely on published revenue rulings in

The second category are unpublished private rulings, which are written statements issued to a taxpayer to interpret and apply the tax laws to the taxpayer's specific set of facts.²⁹ General Counsel Memoranda, which are legal opinions of the IRS Chief Counsel, also figure prominently.³⁰

Lack of regulations for the categorization of integral parts, section 115 entities, and instrumentalities leads to inconsistency and produces arbitrary differences. These differences involve both whether the enterprise is considered a separate entity and whether the income of the enterprise is exempt from federal income taxation. The tests for instrumentalities are the most fully developed and thus provide a starting point for developing regulations applicable to all three categories of government affiliates.

A. Status as Political Subdivision

Although this Article focuses on affiliates of states and political subdivisions, an overview of the tax treatment of states and political subdivisions is necessary for understanding the treatment of their affiliates. States and political subdivisions are exempt from income taxation under an implied statutory immunity.³¹ An entity is a political subdivision if it has at least some of the sovereign powers of taxation, eminent domain, and police power.³² The rulings are unclear how substantial the entity's sovereign powers must be to qualify.

That states and their political subdivisions are not subject to federal income tax is set forth in Revenue Rulings 71-131³³ and 71-132,³⁴ both of which are and cryptic and conclusory. Their headnotes indicate they are rulings under section 61, the definition of gross income. Each ruling quotes state statutes—Montana in Revenue Ruling 71-131, and Oregon in Revenue Ruling 71-132—which establish state control of liquor sales and liquor stores. Each ruling summarily holds that income states derive from state-owned liquor stores is not subject to federal income tax. However, no explanation is given in either ruling.³⁵ A recent revenue ruling offers a bit more analysis: "Income earned by a

applying the principles of such a ruling to the facts of their cases. *Id.* at ¶ 110.5.4.

29. *Id.* at ¶ 110.5.1. Only the taxpayer to whom a private ruling is issued may rely upon it. *Id.* at ¶ 110.5.4. However, taxpayers often consult private rulings for a sense of the IRS position. Private letter rulings do not receive as extensive a review within the IRS as revenue rulings and are not reviewed by Treasury's Office of Tax Policy. *Id.* at 110.5.4.

30. IRS MANUAL § (30) 722 (1985) available in LEXIS, Fedtax Library, Manual file. In the past, the ruling division would ask the interpretive division for an opinion on a proposed ruling. General Counsel Memoranda were "memoranda written by the IRS Office of Chief Counsel in response to requests for legal advice from the Office of the Assistant Commissioner (Technical). These two branches have now been combined, except in the Division of Employee Plans and Exempt Organizations." Ian K. Loudon, *Decline in Publication of IRS Internal Memoranda Sparks Growing Concern*, 44 TAX NOTES 638, 639 (1989). Currently, General Counsel Memoranda will be issued only for issues related to employee plans and exempt organizations. *Id.*

31. See Rev. Rul. 71-131, 1971-1 C.B. 28; Gen. Couns. Mem. 14,407 (Jan. 28, 1934).

32. See *infra* notes 37-52 and accompanying text.

33. 1971-1 C.B. 28.

34. 1971-1 C.B. 29.

35. These rulings supersede Gen. Couns. Mem. 14,407, C.B. XIV-1, 103 (Jan. 28, 1935). Although Gen. Couns. Mem. 14,407 has been superseded by Rev. Rul. 71-131, 1971-1 C.B. 28, it continues to be frequently cited. See, e.g., Rev. Rul. 77-261, 1977-2 C.B. 45; Gen. Couns. Mem. 34,476 (Apr. 9, 1971); Gen. Couns. Mem. 39,601 (Jan. 30, 1987); Priv. Ltr. Rul. 89-20-056 (Feb. 22, 1989); Priv. Ltr. Rul. 82-33-074 (May 19, 1982); Priv.

state, a political subdivision of a state, or an integral part of a state or political subdivision of a state is generally not taxable in the absence of specific statutory authorization for taxing such income.”³⁶

To determine whether an entity is a political subdivision and, thus, not subject to income taxation under the statutory immunity, the IRS applies regulations promulgated under section 103 of the Internal Revenue Code.³⁷ Section 103(a) excludes from gross income “interest on any State or local bond.”³⁸ Section 103(c) defines “State or local bond” as “an obligation of a State or political subdivision thereof.”³⁹ Regulation section 1.103-1(b) provides, in part, that “political subdivision” refers to “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.”⁴⁰

The IRS defines sovereign power by reference to *Estate of Shamberg*,⁴¹ one of the few decisions on what constitutes a political subdivision within the meaning of section 103.⁴² According to *Estate of Shamberg*, three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the police power.⁴³ In *Estate of Shamberg*, the Tax Court found that interest on bonds issued by the Port of New York Authority were excluded from gross income because the Port Authority constituted a political subdivision of a state under the statutory predecessor of section 103.⁴⁴ Although the Port Authority lacked the power to tax, it was “endowed with the power of eminent domain, and with certain police powers, including the promulgation and enforcement of regulations for the conduct of navigation and commerce in the area defined as the Port of New York District.”⁴⁵

The IRS announced in Revenue Ruling 77-164⁴⁶ that all three sovereign powers described in *Shamberg* need not be delegated for an organization to be a political subdivision for purposes of section 103. Thus, rulings regularly grant political subdivision status

Ltr. Rul. 82-43-087 (July 27, 1982); Priv. Ltr. Rul. 80-37-109 (June 20, 1980). For a discussion of Gen. Couns. Mem. 14,407 and the IRS position that the constitutional doctrine of intergovernmental immunity does not prevent taxation of states and political subdivisions, see Aprill, *supra* note 7, at 424-34.

36. Rev. Rul. 87-2, 1987-1 C.B. 18. The quoted language is now the standard language in private letter rulings involving the issue. See, e.g., Priv. Ltr. Rul. 97-33-003 (May 9, 1997); Priv. Ltr. Rul. 97-30-001 (Oct. 4, 1996); Priv. Ltr. Rul. 93-47-001 (July 26, 1993). In the view of the IRS, I.R.C. § 511(a)(2)(B) represents a statutory override of the implied statutory immunity of political subdivisions. See Gen. Couns. Mem. 37,657 (Aug. 31, 1978). I.R.C. § 511(a)(2)(B) imposes unrelated business income tax on “any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions.” I.R.C. § 511(a)(2)(B).

37. See Gen. Couns. Mem. 36,994 (Feb. 3, 1977). The IRS concluded that the definition of a political subdivision included in the regulations under section 103 should be used in interpreting other provisions of the Code involving political subdivisions. *Id.*

38. I.R.C. § 103(a) (1997).

39. I.R.C. § 103(c) (1997).

40. Treas. Reg. § 1.103-1(b) (1997).

41. 3 T.C. 131, (1944), *aff'd*, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945).

42. See *Philadelphia National Bank v. United States*, 666 F.2d 834 (3d Cir. 1981) (finding Temple University is not a political subdivision under section 103).

43. See *Shamberg*, 3 T.C. at 142.

44. *Id.*

45. *Id.*

46. 1977-1 C.B. 20.

to entities that have only one of these powers, such as a library district with the power of taxation,⁴⁷ a school district with the power of eminent domain,⁴⁸ or a health care authority with the power of eminent domain.⁴⁹

Nonetheless, "possession of only an insubstantial amount of any or all sovereign powers is not sufficient. All of the facts and circumstances must be taken into consideration, including the public purposes of the entity and its control by a government."⁵⁰ Thus, a university's power to preserve order and public safety on its campus through campus police, for example, is not considered an exercise of police power.⁵¹ Police power "embraces regulations designed to promote the public convenience or the general prosperity, as well as regulations designed to promote the public health, the public morals or the public safety."⁵² Campus police, in contrast, have "a limited authorization to exercise one small aspect of police power—one that has been delegated to private organizations as well."⁵³

Other rulings appear to ignore sovereign powers rather than evaluate them as insubstantial. This approach is seen most often when a state or municipal instrumentality argues for eligibility for exemption under section 501(c)(3). Governmental institutions may desire exemption under section 501(c)(3) for a variety of reasons, including enhanced fundraising and preferential postal rates.⁵⁴ A governmental institution can qualify if it is a clear counterpart of a charitable, religious, or similar organization,⁵⁵ but will not be considered a counterpart if it possesses sovereign powers and thus qualifies as a political subdivision.⁵⁶ The IRS blithely ignores limited powers of eminent domain or taxation in determining eligibility for status under section 501(c)(3).⁵⁷ Thus, many governmental institutions can choose whether to be treated as a political subdivision with sovereign powers or as a charity that lacks such powers. They choose by either applying for exempt status under section 501(c)(3) or by seeking a private ruling as a political subdivision.

47. See Priv. Ltr. Rul. 89-21-024 (Feb. 21, 1989).

48. See Priv. Ltr. Rul. 93-27-072 (April 12, 1993).

49. See Priv. Ltr. Rul. 97-30-001 (Oct. 4, 1996).

50. Rev. Rul. 77-164, 1977-1 C.B. 20, 21.

51. See *id.*; see also *Philadelphia Nat'l Bank v. United States*, 666 F.2d 834, 840 (3d Cir. 1981) (observing the inconsistency between Revenue Ruling 77-1 and earlier revenue rulings regarding delegation of the power to tax as an aspect of sovereignty).

52. *Philadelphia Nat'l Bank*, 666 F.2d at 840 (3d Cir. 1981) (quoting *Chicago, Burlington & Quincy Ry. Co. v. Illinois ex rel Drainage Comm'rs*, 200 U.S. 561, 592 (1906)).

53. *Id.*

54. See Steven Simpson, *Tax-Exempt Organizations: Organization, Operation and Reporting Requirements*, 870 TAX MANAGEMENT PORTFOLIOS V(D) at A-50 (explaining why government entities seek exemption and discussing exemption standards).

55. See Rev. Rul. 74-15, 1974-1 C.B. 126 (finding library to be a clear counterpart, even though it had power to determine supportive tax rate, because it lacked the power to levy the tax); Rev. Rul. 55-319, 1955-1 C.B. 119 (holding that a wholly-owned state instrumentality may qualify for exemption under section 501(c)(3)).

56. See, e.g., Rev. Rul. 74-15, 1974-1 C.B. 126 (public library); Rev. Rul. 60-384, 1960-2 C.B. 172 (wholly-owned state or municipal entity may qualify for exemption under section 501(c)(3) in some circumstances); Rev. Rul. 55-319, 1955-1 C.B. 119 (same).

57. See Rev. Rul. 74-15, 1974-1 C.B. 126 (finding a public library with power to determine tax rates necessary to fund its operations qualifies for exemption under section 501(c)(3)); Rev. Rul. 67-290, 1967-2 C.B. 183 (public hospital with power of eminent domain for property essential to its services qualifies for exemption under section 501(c)(3)); IRS, *supra* note 14, at 5(B).

Although the nature and extent of sovereign powers required for an entity to qualify as a political subdivision are far from clear, a detailed critique of the section 103 regulations, which are used primarily for determining whether interest on municipal bonds is taxable, is beyond the scope of this Article. This Article does not focus on political subdivisions themselves, but on the three categories of entities related to them in varying degrees—integral parts, section 115 entities, and instrumentalities.

B. Integral Parts

An organization without any sovereign powers can be exempt from federal income tax as an integral part of a state or political subdivision. The IRS treats an organization controlled by government officers and operated without any independent organizational form as an integral part of a governmental unit.⁵⁸ Thus, governmental departments such as state lotteries are integral parts not subject to taxation.⁵⁹ When a governmental organization has what looks like an independent organizational form but is under the control of a state or political subdivision, tax rulings sometimes treat it as an integral part and sometimes not. Recent rulings have looked not only to degree of control, but have also added the requirement of financial commitment by the state or political subdivision.⁶⁰ For both of these key considerations, the IRS applies a facts and circumstances test that leads to strikingly inconsistent results.

Historically, degree of control has been particularly important in qualifying an enterprise as an integral part.⁶¹ As an IRS training text explains:

If a state is substantially involved in the activities of an organization, that organization will be considered an integral part of the state or municipal government. Factors that indicate state involvement include (1) creation of the organization by executive order of the governor of a state, (2) creation of the organization by executive order of the governor of a state as an official state agency, (3) a state or a state agency having the power to appoint and remove the organization's board, (4) a state or a state agency having the power to abolish the organization, (5) a state or a state agency monitoring the organization's activities, and (6) the organization using government employees to conduct its activities.⁶²

If such factors are present, the IRS often finds an organization to be an integral part of government despite declarations in its organizing documents that it is a body politic and corporate.⁶³ Other rulings, however, ignore the degree of control and treat an entity described in its organizing documents as a "body politic and corporate" as a separate entity, rather than an integral part. Classifying the entity as separate forces the organization to run the gauntlet of section 115, with its own tests for exclusion of income.⁶⁴

58. See, e.g., Rev. Rul. 87-2, 1987-1 C.B. 18; Gen. Couns. Mem. 39,601 (Jan. 30, 1987).

59. See Aprill, *supra* note 7, at 487-89.

60. See, e.g., Priv. Ltr. Rul. 97-33-003 (May 9, 1997); Priv. Ltr. Rul. 97-06-006 (Nov. 8, 1996); Priv. Ltr. Rul. 96-27-016 (Apr. 5, 1996); Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996).

61. See *supra* note 58.

62. IRS, *supra* note 14.

63. See *supra* note 58.

64. See, e.g., Gen. Couns. Mem. 34,179 (Aug. 5, 1969) (finding a trust fund was not an integral part but

A comparison between Revenue Ruling 87-2,⁶⁵ the key published authority regarding the integral part doctrine,⁶⁶ and an earlier General Counsel Memorandum, sharply exposes the contrast regarding separateness. In Revenue Ruling 87-2, the IRS concluded that a Lawyer Trust Account Fund created, supervised, and controlled by a state supreme court was an integral part of the state and thus not subject to income tax.⁶⁷ In General Counsel Memorandum 34,179,⁶⁸ however, a trust fund created, supervised, and controlled by a state supreme court to reimburse citizens injured by attorney defalcation was not an integral part of the state because it was independently organized and operated.⁶⁹

The IRS is aware of this inconsistency. General Counsel Memorandum 39,601, which supplies the background to Revenue Ruling 87-2,⁷⁰ frankly describes the earlier memorandum as wrong: "[W]e believe that the trust fund in GCM 34179 was an integral part of the state."⁷¹ General Counsel Memorandum 39,601, however, goes beyond concluding that the earlier memorandum was erroneous. The Memorandum recommends "[i]gnoring, in appropriate cases, the declarations of corporate existence of entities created at the urging of public officials or a public agency, especially where the entity is entirely subservient to the wishes of the officials of the agency."⁷²

When the entity is not subservient, however, the IRS may decline to ignore declarations of corporate existence and refuse to treat a body corporate and politic as being an integral part of a political subdivision. General Counsel Memorandum 38,921, for example, found that the declaration of corporate existence was controlling in the case of a housing authority when state officials did not dominate the housing authority.⁷³

In sum, for purposes of categorizing an entity as an integral part of a political subdivision, the IRS treats separateness as more of a matter of governmental control than corporate organization. For example, none of the rulings treating an entity as an integral part of a state or local government looked to the regulations promulgated under section 7701, which, until amended in 1996, determined whether or not an organization is to be treated as a taxable entity separate from its owners according to a weighing of characteristics.⁷⁴

section 115 entity); Gen. Couns. Mem. 34,704 (December 2, 1971) (finding a pension plan was not an integral part, but a section 115 entity).

65. 1987-1 C.B. 18.

66. Private letter rulings frequently cite Rev. Rul. 87-2. *See, e.g.*, Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996); Priv. Ltr. Rul. 95-07-037 (Nov. 21, 1994); Priv. Ltr. Rul. 94-01-017 (Oct. 8, 1993).

67. *See* Rev. Rul. 87-2, 1987-1 C.B. 18.

68. *See* Gen. Couns. Mem. 34,179 (Aug. 5, 1969).

69. *Id.*

70. Often, the genesis of a General Counsel Memorandum has been a request by the Office of the Assistant Commissioner that the Office of Chief Counsel comment on a proposed revenue ruling. *See* Loudon, *supra* note 30, at 639.

71. Gen. Couns. Mem. 39,601 (Jan. 30, 1987).

72. *Id.* Other General Counsel Memoranda have also urged this result. *See, e.g.*, Gen. Couns. Mem. 37,657 (Aug. 31, 1978).

73. *See* Gen. Couns. Mem. 38,921 (July 29, 1982). This memorandum also noted that the housing authority was not dependent on funds appropriated by any state or local governmental unit. *Id.* *See also* Priv. Ltr. Rul. 89-34-052 (May 31, 1989) (finding that an art commission whose members were appointed by a city and county and which received the majority of its funds from governmental sources was a section 115 entity, although it was not an integral part because it was created under a State statute that made it a separate body "corporate and politic").

74. Treas. Reg. § 301.7701-2 (1995) (amended in 1996 by T.P. 8697). The four characteristics were con-

The same is not true when a governmental organization seeks to qualify under section 501(c)(3). To qualify under section 501(c), the organization must establish that it is a separately organized entity.⁷⁵ Private letter rulings recognizing governmental entities as separate for purposes of section 501(c)(3) rely on section 7701 regulations.⁷⁶ As a result, the IRS has permitted a variety of governmental entities to qualify as separate for the purposes of satisfying section 501(c)(3), regardless of the degree of governmental control.⁷⁷ One private ruling, for example, concludes that an entity is an integral part of a political subdivision, but cautions that the ruling will be withdrawn if the entity obtains section 501(c)(3) status.⁷⁸

Thus, the IRS employs a double standard regarding an entity's separate status for purposes of section 501(c)(3), just as it did regarding possession of sovereign powers in the case of qualification as a section 501(c)(3) organization. Again, many governmental institutions in fact have a choice: to be treated either as an integral part of a political subdivision or as a charity that is organized as a separate entity. They make the choice by deciding under which category to seek a ruling.

Effective January 1, 1997, the IRS issued a new set of classification regulations under section 7701.⁷⁹ These regulations further demonstrate the double standard for separateness of governmental entities. Known as the "check-the-box regulations,"⁸⁰ they establish an elective system that permits eligible entities to choose to be taxed separately from their owners (i.e., as corporations) or as a pass-through entity to their owners. The regulations explain that "[a]n 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."⁸¹ The regulation gives no guidance as to what constitutes an integral part.

The regulations also list a set of organizations that must be treated separately from their owner as *per se* corporations. The lists includes "a business entity organized under a Federal or State statute ... if the statute describes or ... refers to the entity as incorporated or as a corporation, body corporate or body politic" and "a business entity wholly owned by a State or any political subdivision thereof."⁸² Thus, these new regulations, like the rulings, take the less than helpful position that a body corporate and politic is *per se* separate from the political subdivision that owns it, unless it isn't. The regulations do nothing to resolve the question of whether separateness is a matter of organizational form or governmental control.

tinuity of life, centralized management, limited liability, and transferability of interests. *Id.*

75. See Rev. Rul. 60-384, 1960-2 C.B. 172; see also IRS, *supra* note 14.

76. See Priv. Ltr. Rul. 88-32-056 (May 18, 1988); Priv. Ltr. Rul. 88-39-039 (June 30, 1988).

77. *Id.*

78. See Priv. Ltr. Rul. 88-32-056 (May 18, 1988).

79. Treas. Reg. § 301-7701-1 (1997).

80. See, e.g., Hugh M. Dougan et al., 'Check the Box' - Looking Under the Lid, 75 TAX NOTES 1141 (1997); Reuven S. Avi-Yonah, *To End Deferral As We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219 (1997); Scott D. Smith, *What Are States Doing on the Check-the-Box Regs?*, 76 TAX NOTES 973 (1997).

81. Treas. Reg. § 301.7701-1(a)(3) (1997); Priv. Ltr. Rul. 98-22-011 (Feb. 3, 1998) (finding state owned corporation both a separate entity from the state and an integral part).

82. Treas. Reg. § 301.7701-2(b)(1)&(6) (1997).

To confuse matters further, in recent rulings, the relationship between control and separateness did not resolve the question of whether a governmental enterprise qualified as an integral part. All of the most recent rulings recognizing an enterprise as an integral part of a state or political subdivision have stated that a determination of whether an enterprise is an integral part of a state must include, among other factors, the degree to which the state controls the enterprise and how much of a financial commitment the state has made to the enterprise.⁸³ Thus, these rulings have introduced another condition, financial commitment, in addition to the requirement of control.

These rulings neither explain the reason for this requirement, nor acknowledge it as a new criterion. Each ruling cites *Maryland Savings-Share Insurance Corp. v. United States*⁸⁴ as the only support for the requirement. That case involved the status of the Maryland-Share Insurance Corporation (MSSIC), which the State of Maryland established to insure member savings and loan associations after the collapse of a number of savings and loan associations in the 1950s and 1960s.⁸⁵ The district court denied MSSIC exemption because the state had made no financial contribution: "With MSSIC, the state has absolutely no financial obligations. At no time will the reduction in accumulated earnings caused by federal taxation of MSSIC's income cause the state to pay anything out to MSSIC or its creditors. No state funds are part of the capital which produces MSSIC's income; all such funds are derived from member associations."⁸⁶

MSSIC emphasizes the source of funding as a basis for exemption as a governmental entity, and under *MSSIC*, premiums charged to purchase insurance did not count as financial commitment of the state. MSSIC, however, was denied exemption under section 115 and not under the integral part doctrine. As discussed below, when the IRS tests for qualification under section 115, it looks not to the source of the entity's funds, as *MSSIC* counsels, but to the destination of the funds.⁸⁷ The IRS applies the requirement of financial commitment, which *MSSIC* established as applicable to section 115 entities, to the integral part doctrine.

The requirement of financial investment borrowed from *MSSIC* seems to be an odd condition for an entity to qualify as an integral part, particularly if it requires on-going infusions of government money. When a governmental activity is not organized as a body corporate, there is no such requirement. Governmental units or divisions, such as state lotteries, are free to make money for the state rather than take money from other state revenues. Since an integral part is treated as a division of the government, it would seem that it should be free to do the same. The use to which the IRS now puts *MSSIC* for judging integral part evidences its confusion between this category and section 115 entities. At the same time, the impulse of the IRS to apply a test developed for one category

83. See Priv. Ltr. Rul. 97-33-003 (May 9, 1997); see also, e.g., Priv. Ltr. Rul. 98-22-011 (Feb. 3, 1998); Priv. Ltr. Rul. 97-06-006 (Nov. 8, 1996); Priv. Ltr. Rul. 96-27-016 (Apr. 5, 1996); Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996). See *infra* Part III.B.

84. 308 F. Supp. 761 (D. Md. 1970), *rev'd on other grounds*, 400 U.S. 4 (1970).

85. *Id.* at 763.

86. *Id.* at 765-66. Although the Supreme Court reversed the district court on other grounds relating to MSSIC's eligibility for exemption under section 501(c)(14), the Court agreed that MSSIC was not exempt either as an instrumentality or under section 115. 400 U.S. at 7 n.2.

87. See *infra* Part II.C.

of governmental affiliates to another category reflects the close relationship between the two categories.

In sum, the tests used by the IRS for qualification of governmental entities as integral parts of states or their political subdivisions involve control and financial commitment. Application of such tests is amorphous and shifting. It is difficult to predict when the supervision of governmental officials will be deemed sufficient for such status or when an entity will be deemed separately organized. In addition, some kind of initial financial commitment on the part of the state or political subdivision now seems necessary, although the basis and the reach of such a requirement are questionable. The use by the IRS of this financial commitment test for qualification as an integral part raises questions about the relationship between the integral part doctrine and section 115.

C. Section 115 Entities

Income is excluded from taxation under section 115(1) if it is derived from the exercise of any essential governmental function and accrues to a state or political subdivision.⁸⁸ For purposes of section 115, the IRS requires as a threshold matter that the income be earned by an entity separate from a state or political subdivision.⁸⁹ Thus, exclusion of income under section 115 has a close logical relationship to immunity from taxation as an integral part. An entity is an integral part if it is deemed not to be separately organized. If it is deemed to be separate, the IRS goes on to test for eligibility under section 115.⁹⁰ In spite of this close relationship, the IRS applies different tests under section 115 and the integral part doctrine. Under section 115, the IRS asks whether the entity makes or saves money for political subdivisions, whether its assets revert to the state upon dissolution, and whether private parties benefit.⁹¹ It does not consider control of the entity, which is a key consideration under the integral part doctrine.

A governmental enterprise could, in many cases, qualify as either an integral part or as a section 115 entity. As discussed above, there is a great deal of flexibility in determining whether or not an entity is an integral part. By seeking a ruling that it is eligible under section 115, an enterprise chooses to be treated as a separate entity. In some cases, however, the IRS itself applies section 115 because it concludes that the nature of the entity requires it to be treated as a separate entity, regardless of the degree of governmental control over its activities.⁹²

Various authorities demonstrate the close relationship between the integral part doctrine and section 115. The preamble to the proposed check-the-box regulations classifying entities as corporations or partnerships under section 7701 states, "Organizations wholly owned by a State that are not an integral part of the State must be recognized for federal tax purposes and scrutinized under section 115...."⁹³ General Counsel Memorandum

88. I.R.C. § 115(1) (1997).

89. See Gen. Couns. Mem. 14,407, *supra* note 35; Aprill, *supra* note 7; see also *infra* notes 93-94 and accompanying text.

90. See *supra* note 64 and accompanying text.

91. See *infra* notes 102-109 and accompanying text.

92. See *infra* notes 98-99.

93. 61 Fed. Reg. 21,989, 21,991 (1996). The preamble further notes, "Nevertheless, under section 115, the organization's income may not be subject to federal income tax." *Id.* Treas. Reg. § 301.7701-2(b)(6) (1997) classifies as a *per se* corporation a "business entity wholly owned by a State or any political subdivi-

dum 39,315, which involved exemption of the income of a board created by a state supreme court to ensure satisfaction of continuing legal education requirements, concludes, "Since the Board's income is not subject to federal income tax, either under Rev. Rul. 77-261 if the board is an integral part of the state or a political subdivision, or under section 115 if it is not, it is not necessary to determine whether the Board is part of the state government." ⁹⁴

In other rulings, the IRS did not view categorization as an integral part or a section 115 entity as a matter of indifference. In General Counsel Memorandum 34,704,⁹⁵ for example, the IRS Chief Counsel agreed with the Assistant Commissioner (Technical) that a public employees' retirement fund and an industrial accident fund should not be subject to federal taxation, but disagreed over whether they were integral parts of the state. Since each was organized as a trust, the memorandum reasoned, "it must be regarded as legally separate from its governmental creator for purposes of the Internal Revenue Code."⁹⁶ The General Counsel Memorandum, however, went on to conclude that both funds were instrumentalities and exempt under section 115.⁹⁷

In many other cases, the entity seeking section 115 status is a consortia or pool of many political subdivisions, and thus could not be an integral part of any one of its members.⁹⁸ The most recently published section 115 ruling, for example, concerns governmental liability pools. Revenue Ruling 90-70 declares that 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, is excluded from gross income under section 115.⁹⁹ Similarly, the other published ruling involving section 115 involved an investment fund "established under a written declaration of trust by a State, for the temporary investment of cash balances of the State and its political subdivisions..." ¹⁰⁰

Had these pools and consortia been eligible under the integral part doctrine, the IRS would have looked only to the degree of control by governmental officials and the degree of financial commitment from the state or its political subdivisions. Section 115, however, requires that the income to be excluded be derived from "the exercise of any essential governmental function" and "accruing to a State or any political subdivision."¹⁰¹

sion thereof. . . ." The regulations do not define either "business entity" or "wholly owned." They thus avoid many difficult issues, some of which this article attempts to address.

94. Gen. Couns. Mem. 39,315 (Dec. 21, 1984).

95. Gen. Couns. Mem. 34,704 (Dec. 2, 1971).

96. *Id.* at 5 (quoting G.C.M. 34502 (May 21, 1971) at 4).

97. *Id.* at 10.

98. Dozens of private rulings have been issued which conclude that income of governmental pooled liability funds is excludable from gross income. *See, e.g.,* Priv. Ltr. Rul. 90-50-055 (Sept. 19, 1990) (noting that pooling enables political subdivisions to reduce loss exposure and take advantage of economies of scale); Priv. Ltr. Rul. 90-46-060 (Aug. 23, 1990) (addressing the essential governmental function served by the association under consideration); Priv. Ltr. Rul. 90-45-021 (Aug. 10, 1990) (highlighting the direct benefit to the individual local government); Priv. Ltr. Rul. 90-43-067 (Aug. 2, 1990) (finding that plan undertakes an activity which may be properly conducted by the sovereign); Priv. Ltr. Rul. 90-43-047 (July 31, 1990) (noting that the income does not "inure[] to the benefit of any private person").

99. Rev. Rul. 90-70, 1990-2 C.B. 34. The ruling also requires that any private benefit be incidental to public benefit. *See infra* Part III for a discussion of incidental benefits.

100. Rev. Rul. 77-261, 1977-2 C.B. 45.

101. I.R.C. § 115(1) (1997).

As a result, in exempting these pooled funds, the IRS has not examined control. Instead, it has applied the statutory requirements in both published and private rulings, and in doing so has adopted astonishingly liberal interpretations of both “essential governmental function” and “accrue.”

For purposes of section 115, anything that makes or saves the political subdivisions money serves an essential governmental function. For example, the fact that an investment trust generates a positive cash balance satisfies the essential government function test.¹⁰² The pooled liability fund protects the “financial integrity” of the political subdivisions. As one of the private letter rulings explains, a pooled insurance fund provides “coverage at a lower cost than could be obtained commercially.”¹⁰³ Under this reasoning, however, a section 115 entity cannot break even or lose money.

Revenue Ruling 90-74 explains that the accrual test is satisfied if, upon dissolution, assets go to political subdivisions.¹⁰⁴ The IRS does not interpret accrual as requiring that the political subdivisions have any current right to the income or assets.

The tests for section 115, then, are very different from those for integral part. For a section 115 entity, unlike an integral part, the IRS does not examine the degree of control exercised over the entity by the political subdivision. Nor does the IRS require any initial financial commitment from the state or political subdivision, even though *MSSIC* required financial obligations from the state to satisfy section 115. Section 115 qualification looks at the ultimate destination, not the source, of the funds, perhaps on the assumption that the right to assets upon dissolution evidences ownership and control.

The IRS interpretation of section 115 is far more generous than judicial interpretations. In Supreme Court cases decided close to the time of the enactment of section 115, essential governmental function did not include raising revenues.¹⁰⁵ A right to assets upon dissolution did not satisfy the accrual test either. In *Omaha Public Power District v. O'Malley*,¹⁰⁶ the Eighth Circuit required a vested right or an enforceable claim by the political subdivision to satisfy the accrual test.¹⁰⁷

Though the IRS broadly defines essential governmental function and accrual, it has added an additional requirement to section 115. This requirement, not found in the statutory language, prohibits anything but incidental private benefit. Thus, Revenue Ruling 90-74 asserts repeatedly that any private benefit to employees from political subdivisions insuring against casualty risks and other risks arising from employee negligence is “incidental to the public benefit.”¹⁰⁸ For the IRS, the private benefit test has become a key test under section 115. For example, a recent ruling states that “section 115 does not apply to an entity’s income if there is more than an incidental private benefit connected with the income.”¹⁰⁹

102. See, e.g., Rev. Rul. 77-261, 1977-2 C.B. 45.

103. Priv. Ltr. Rul. 87-53-008 (Oct. 1, 1987).

104. Rev. Rul. 90-74, 1990-2 C.B. 34.

105. See *Allen v. Regents of the Univ. System*, 304 U.S. 439 (1938) (admission to athletic events); *South Carolina v. United States*, 199 U.S. 437 (1905) (liquor sales). For further discussion of these cases and the legislative history of section 115, see Aprill, *supra* note 7, at 425-27.

106. 232 F.2d 805 (8th Cir. 1956), *cert. denied*, 352 U.S. 837 (1956).

107. *Id.* at 810.

108. Rev. Rul. 90-74, 1990-2 C.B. 45.

109. Priv. Ltr. Rul. 97-33-003 (May 9, 1997) (ruling on status of certain settlement funds under section

Use of this private benefit standard is questionable. No such inquiry is made under the integral part doctrine to which section 115 is closely related. In other contexts, as discussed above,¹¹⁰ the IRS has granted section 115 status to pension plans for government employees who benefit as private individuals.¹¹¹ More fundamentally, the IRS created out of thin air the basic principle, prohibition of direct private benefit, that it claims applies under section 115. In applying the principle it invented, the IRS usurped state sovereignty by substituting its own judgment for the judgment of the state as to what is a public purpose. The state's sovereign powers surely include defining what is in the public interest. By introducing this requirement, the IRS has claimed the authority to define what is an essential governmental function, a determination that the Supreme Court has declared impossible.¹¹²

At the time section 115 was enacted in 1913, the Supreme Court had recently distinguished essential governmental activities from proprietary ones.¹¹³ On the basis of this distinction, liquor sales by the state of South Carolina were subject to federal excise tax.¹¹⁴ Similarly, the Interborough Rapid Transit Company, a privately-held corporation engaged in providing a public service, was liable for a federal corporate excise tax in *Flint v. Stone Tracy Company*.¹¹⁵ Applying the governmental/proprietary distinction sketched out in *South Carolina v. United States* and *Flint*, however, soon produced inconsistent results. According to *Helvering v. Powers*,¹¹⁶ the compensation of the Boston Elevated Railway Company Board of Trustees was not exempt from the federal income tax on the basis that the activity was proprietary rather than governmental.¹¹⁷ Just three years later, *Brush v. Commissioner*¹¹⁸ held the salary of the chief engineer of New York City's water supply exempt from federal income tax, because operation of a water system had developed into an exercise of the city's governmental function.¹¹⁹

Faced with such inconsistencies, the Supreme Court concluded in *New York v. United States*¹²⁰ that a governmental/proprietary distinction was untenable.¹²¹ As Justice

115 and implied statutory immunity).

110. See *supra* notes 95-97 and accompanying text.

111. See Priv. Ltr. Rul. 88-25-087 (Mar. 28, 1988); see also Gen. Couns. Mem. 34,704 (Dec. 2, 1971) (discussing whether the Public Employees' Retirement Fund and the Industrial Accident Fund are integral parts of the state and therefore exempt from taxation).

112. See *New York v. United States*, 326 U.S. 572, 583 (1946) (declaring that a governmental vs. proprietary distinction was untenable).

113. See *South Carolina v. United States*, 199 U.S. 437, 438 (1905) (explaining South Carolina's dispensary system for liquor sales engaged in the state in ordinary private business which is subject to federal taxation and noting that "[t]he exemption of state agencies and instrumentalities from national taxation is limited to those which are of strictly governmental character, and does not extend to those used by the State in carrying on an ordinary private business").

114. *Id.*

115. 220 U.S. 107, 172 (1911) (holding in part that "public service corporations, represented in the cases at bar, are not exempt" from the federal corporation tax).

116. 293 U.S. 214 (1934) (finding activity was a departure from usual governmental functions).

117. *Id.* at 227.

118. 300 U.S. 351 (1937) (concluding the "acquisition and distribution of a supply of water," in consideration of the public uses served by such distribution, "involve the exercise of essential governmental functions").

119. *Id.* at 371.

120. 326 U.S. 572 (1946).

Frankfurter wrote, the distinction “was too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion.”¹²² More recently, *Garcia v. San Antonio Metropolitan Transit Authority*¹²³ relied on the rejection of the governmental/proprietary distinction for intergovernmental tax immunity to deny states “judicially created limitations on federal power” for protection of state sovereign interests.¹²⁴ The 5-4 majority opinion in *Garcia* pointed out not only the “unworkability” of an essential/nonessential distinction, but also the “inability” to give any such distinction “principled content.”¹²⁵

Yet, by requiring the balancing of private and public benefit, the IRS has set itself up as the arbiter of the distinction. Should a state or political subdivision engage in activities that produce revenue, the IRS will accept the activity as an essential one. Should the state or political subdivision engage in activity to correct a market failure and thus benefit its citizens, the IRS may well deem the activity as providing more than an incidental private benefit. By introducing the requirement of only incidental private benefit, then, the IRS had placed a wedge between the integral part doctrine and section 115, despite the logical relationship between the two. For integral parts, the IRS looks to the extent of governmental control; such control in and of itself serves to assure adequate public benefit. For section 115, the IRS does not examine control, but rather makes its own decision as to whether the public benefit is adequate; examination of public and private benefit substitutes for examination of control.

The IRS seems to have imported this balancing of private and public interests from section 501(c)(3). A section 501(c)(3) organization can lose its exemption if it operates for the benefit of private rather than public interests,¹²⁶ but the prohibition on private benefit is not absolute. Private benefit is permitted so long as it is incidental to the accomplishment of the public benefit. This determination may require balancing of the private and public interests served by an activity.¹²⁷ One case does this balancing “by examining the definiteness and charitable nature of the class to be benefited and the overall purpose for which the organization is operated.”¹²⁸ When the IRS compares public and private interests in the case of charities, it undertakes a difficult task. Charities receive exemptions only for specific purposes that give the IRS a basis for comparison. In contrast, the purposes of state and local governments are not so limited.

121. *Id.* at 583.

122. *Id.* at 580 (plurality opinion) (Frankfurter, J., announcing the judgment of the Court).

123. 469 U.S. 528 (1985).

124. *Id.* at 552.

125. *Id.* at 543.

126. See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1997) (requiring a 501(c)(3) organization to establish that “it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly, by such private interests”); see also *Aid to Artisans, Inc. v. CIR*, 71 T.C. 202, 205 (1978) (denying organization exempt status on grounds that it served private rather than public interests).

127. See *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1069-79 (1989) (distinguishing private inurement and private benefit); *Sonora Community Hosp. v. Commissioner*, 46 T.C. 519, 526 (1966), *aff’d*, 397 F.2d 814 (9th Cir. 1968) (balancing private and public benefit); see also Gen. Couns. Mem. 37,789 (Dec. 18, 1978) (balancing private and public benefit).

128. *Aid to Artisans*, 71 T.C. at 215.

In sum, section 115 and the integral part doctrine are closely related. Section 115 applies if the governmental entity is treated as separate, and the integral part doctrine applies if it is not. However, the IRS applies very different tests to the two doctrines. Unlike the integral part doctrine, examination of corporate governance finds no place in analysis under section 115. The IRS does not, for example, look to statutory authority or decision-making authority in state officials as a means of determining whether the entity serves an essential governmental function for purposes of section 115. For the integral part doctrine, the key is source of funds; for section 115, it is destination of funds. Under the integral part doctrine, the IRS does not balance private and public benefit; for section 115, examination of the extent of private benefit has become the key.¹²⁹ In the case of section 115, the IRS is moving toward a merger of its standards with those for section 501(c)(3), rather than a merger with the standards for the integral part doctrine to which section 115 is more closely related.

D. Instrumentalities

The Internal Revenue Code explicitly recognizes instrumentalities of states and their political subdivisions as a category distinct from political subdivisions.¹³⁰ State and municipal instrumentalities, however, are not exempt from federal income tax by virtue of such status.¹³¹ In *Maryland Savings-Share Insurance Corp. v United States*,¹³² for example, the Supreme Court rejected a corporation's argument that "it was an instrumentality of the State and hence entitled to exemption from federal taxation."¹³³ Status as an instrumentality, however, does offer a variety of tax advantages,¹³⁴ and unlike integral parts or section 115 entities, the IRS has established in published rulings criteria for

129. See *supra* notes 108-109 and accompanying text.

130. An instrumentality must be an entity separate from a political subdivision. An entity is not an instrumentality if it qualifies as a political subdivision or as an integral part of a political subdivision. See, e.g., Rev. Rul. 75-359, 1975-2 C.B. 79 (finding that a voluntary association of counties satisfied the criteria for an instrumentality and did not possess the sovereign powers necessary to be categorized as a political subdivision).

131. In contrast, federal instrumentalities are exempt from federal income tax under section 501(c)(1) if their organizing Act, as amended and supplemented before July 18, 1984, so provides, or if their exemption is specifically provided for in the Code or in a Revenue Act. I.R.C. § 501(c)(1) (1997). Congress amended section 501(c)(1) in 1984 to provide that a corporation formed as a United States instrumentality would be tax-exempt only if so identified in the Code itself or in a Revenue Act to allow for more effective monitoring of statutory tax exemptions for U.S. instrumentalities, which have increased in number in recent years. See JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 1206 (Joint Comm. Print 1984). Exempt federal instrumentalities include the Federal Reserve Bank, the Federal Home Loan Bank, federal credit unions, the Farm Credit Bank, federal production credit associations, federal land bank associations, the National Consumer Cooperative Bank, the Federal Deposit Insurance Corporation, the Federal National Mortgage Association, the Federal Savings and Loan Insurance Corporation, the Pennsylvania Avenue Development Corporation, the Resolution Funding Corporation, and the Pension Benefit Guaranty Corporation. See JAMES MAULE, GROSS INCOME: OVERVIEW AND CONCEPTUAL ASPECTS, 501 TAX MANAGEMENT PORTFOLIO 96; see also BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 665-66 (6th ed. 1992).

132. 400 U.S. 4 (1970).

133. *Id.* at 7, n.2.

134. See *infra* note 136-141 and accompanying text.

qualification as an instrumentality.¹³⁵ These criteria include factors already seen both for status as an integral part and as a section 115 entity. They offer a starting point for developing regulations applicable to all categories of governmental affiliates.

Status as an instrumentality is important for a variety of provisions of the Internal Revenue Code. Services performed in the employ of any “[s]tate, . . . of any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned thereby”¹³⁶ are subject to special rules for purposes of, respectively, Federal Insurance Contributions Act (FICA)¹³⁷ and Federal Unemployment Tax Act (FUTA)¹³⁸ taxes, two forms of payroll taxes. Another provision establishes as a special category retirement plans “established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.”¹³⁹ Status as an instrumentality also affects charitable contribution deductions¹⁴⁰ and eligibility to issue tax-free bonds.¹⁴¹

Over thirty years ago, the IRS announced in Revenue Ruling 57-128 the factors for determining whether an entity is an instrumentality of a government unit for purposes of the payroll tax.¹⁴² The criteria include the following: (1) whether the entity is used for a governmental purpose and performs a governmental function; (2) whether it performs its function on behalf of one or more states or political subdivisions; (3) whether private interests are involved, or whether states or political subdivisions have the powers and interests of an owner; (4) whether control and supervision of the organizations is vested in public authority or authorities; (5) whether express or implied statutory or other authority is needed to create or use the entity, and whether such authority exists; and (6) the degree of the organization’s financial autonomy and the source of its operating expenses.¹⁴³

Using these criteria, the IRS has ruled that a variety of entities qualify as instrumentalities. For example, a sports area commission created pursuant to an agreement between a city and two villages to erect and operate an athletic stadium has qualified as an instrumentality.¹⁴⁴ So has a private industry council established to prepare youth and

135. See Rev. Rul. 57-128, 1957-1 C.B. 311; Rev. Rul. 89-49, 1989-1 C.B. 117.

136. I.R.C. § 3121(b)(7)(F) (1997).

137. See *id.* (limiting the FICA exemption for services performed after July 1, 1991, by an employee of a state, political subdivision, or wholly-owned instrumentality thereof only if the employee is a member of a retirement system); see also I.R.C. § 3121(u)(2) (limiting the FICA exemption as applied to Medicare taxes to certain circumstances).

138. See I.R.C. § 3308 (limiting the FUTA exemption unless specifically granted by some other provision which references § 3301 (the FUTA provisions) by name).

139. I.R.C. § 414(d) (1997).

140. See I.R.C. § 170(b)(1)(A)(v) (1997) (limiting an individual’s charitable contribution deduction for the use of governmental units to 50% of the donor’s basis). Contributions to instrumentalities qualify as “for the use of governmental units.” See Rev. Rul. 75-359, 1975-2 C.B. 79.

141. A loan to an instrumentality will be viewed as a loan to the governmental unit on behalf of the instrumentality. See Priv. Ltr. Rul. 96-24-013 (March 15, 1996); *cf.* Rev. Proc. 82-26, 1982-1 C.B. 476, 478 section 3 (outlining circumstances in which obligations issued by a nonprofit corporation will be ruled to be on behalf of a governmental unit).

142. See Rev. Rul. 57-128, 1957-1 C.B. 311 (describing a voluntary unincorporated organization established by the head of insurance departments of several states to promote uniformity in insurance legislation).

143. *Id.*

144. See Rev. Rul. 65-196, 1965-2 C.B. 388.

unskilled adults for entry into the labor force.¹⁴⁵ Even an instrumentality of an instrumentality, such as a corporation formed by a university to provide its medical school organs for transplantation and research, can qualify as an instrumentality.¹⁴⁶

The requirement of Revenue Ruling 57-128 that states or political subdivisions must have the "interests and powers of an owner" over an instrumentality is particularly important.¹⁴⁷ An entity under the control of private individuals cannot be an instrumentality.¹⁴⁸ Revenue Ruling 65-26 denied a municipal league status as an instrumentality.¹⁴⁹ Although its purpose was to improve municipal government and promote the general welfare of cities and villages, the ruling concluded that although it was governed by municipal officers, they were acting as individuals with no power of agency from their respective municipalities. An incorporated water district was also denied status as an instrumentality because it was operating for private landowner members who would receive their proportionate interests of the water district's property and funds upon dissolution.¹⁵⁰

Structure, source of control, and powers distinguish instrumentalities from political subdivisions on the one hand and private corporations on the other. Revenue Ruling 69-453 denied status as an instrumentality to a soil and water conservation district in Connecticut because the district was in the complete control of private individuals.¹⁵¹ Landowners elected the board of supervisors, who had complete control over corporate operations, including revenue and expenditures. The state law involvement was purely regulatory and the regulations, "like any other corporation that has an effect on the public interest," were "designed to insure the integrity of the corporation but not to direct its operation."¹⁵² In contrast, Revenue Ruling 57-120 concluded that the soil conservation districts in Minnesota qualified as political subdivisions.¹⁵³ Although the state board appointed two of its supervisors and members elected three, Minnesota statutes provided for the establishment of such districts, declared them a government subdivision exercising public powers granted by statute. In addition, in the event of a district's dissolution, all funds and proceeds from the sale of property would go to the State treasury.¹⁵⁴

In many cases, status as an instrumentality does not end the inquiry, because the entity requesting the ruling also desires exemption from income tax. To be exempt, the instrumentality must be determined to be eligible under section 115 or section 501(c)(3).

145. See Priv. Ltr. Rul. 90-18-065 (Feb. 7, 1990).

146. See Priv. Ltr. Rul. 97-27-006 (Mar. 25, 1997); see also Priv. Ltr. Rul. 97-27-005 (Mar. 25, 1997) (ruling that a not-for-profit organization is a qualified instrumentality); Priv. Ltr. Rul. 97-21-029 (Feb. 25, 1997) (ruling that a university-affiliated organization engaged exclusively in charitable, education, and scientific activities qualifies as an instrumentality).

147. See Rev. Rul. 57-128, 1957-1 C.B. 311.

148. See Rev. Rul. 69-453, 1969-2, C.B. 182 (denying status as an instrumentality because the board of supervisors was classified as a group of private individuals rather than an entity with public authority).

149. 1965-1 C.B. 444.

150. See Priv. Ltr. Rul. 91-70-002 (Nov. 8, 1990).

151. 1969-2 C.B. 182.

152. *Id.*

153. 1957-1 C.B. 310; see also Rev. Rul. 59-373, 1959-2 C.B. 37 (finding Colorado soil conservation district to be a political subdivision where state statutes gave the soil conservation district rule making and taxing powers).

154. 1957-1 C.B. 310.

Because classification as an instrumentality entails a conclusion that the entity is a separate entity and is not a political subdivision with sovereign powers, instrumentalities can and do qualify as section 501(c)(3) organizations.¹⁵⁵ The relationship between status as an instrumentality and status as a section 115 entity, however, is particularly close. Private rulings frequently observe that “[s]ection 115 of the Code applies to agencies and instrumentalities that are separate entities.”¹⁵⁶ Another ruling states that an entity is exempt under section 115 “because it is an instrumentality” of the State.¹⁵⁷ Private letter rulings, for example, have concluded that a corporation created to support a commercial district management authority incorporated as a separate nonstock corporation,¹⁵⁸ a corporation organized to establish a juvenile detention center,¹⁵⁹ and a legal entity formed to provide investment opportunities for school districts¹⁶⁰ all qualified as both section 115 entities and as instrumentalities.

Indeed, the instrumentality tests of Revenue Ruling 57-128 are more appropriate and desirable for testing status under section 115 than the prohibition of private benefit suggested in Revenue Ruling 90-74, the section 115 ruling involving pooled liability funds.¹⁶¹ The instrumentality tests, of course, do not avoid all difficulty or ambiguity. The first requirement of governmental purpose and governmental function seems more a conclusion than a criterion. However, the third instrumentality test—whether private interests are involved, or whether states or political subdivisions have the powers and interests of an owner—is a more precise, consistent, and fitting test for section 115 status than the balancing of private and public benefit the IRS has been using under section 115. The “interests of an owner” requirement avoids the need for the IRS to sit in judgment over the sovereign decisions of states and their political subdivisions. At the same time, the requirement that private parties not have the interests of an owner protects against the very abuses at which the IRS aims in its interpretation of the accrual requirement under section 115 and its added incidental private benefit requirement.

The established tests for instrumentalities overlap those for integral part as well as those for section 115 entities. Like the integral part tests, they ask about control and supervision of the entity, statutory or other authority, and the source of finances.¹⁶² While

155. See Priv. Ltr. Rul. 97-27-006 (Mar. 25, 1997) (ruling that a non-profit university medical school was a section 501(c)(3) organization and a wholly-owned state instrumentality; Rev. Rul. 82-218, 1982-2 C.B. 30 (university as both instrumentality and section 501(c)(3) organization; Rev. Rul. 60-384, 1960-2 C.B. 172 (instrumentality can qualify under section 501(c)(3) and be eligible under section 403). In determining eligibility for section 501(c)(3) status, however, the IRS seems to apply a narrow definition of “political subdivision” and a broad definition of “separate.” See *supra* text accompanying notes 54-57 and 75-78; Aprill, *supra* note 7, at 445-46; IRS, *supra* note 14.

156. See, Priv. Ltr. Rul. 95-40-007 (June 29, 1995) (ruling that hospital was exempt under section 501(c)(3), and income was excludable under section 115(1)); Priv. Ltr. Rul. 92-04-040 (Oct. 29, 1991) (ruling that the income of a nonprofit company was excludable under section 115); Priv. Ltr. Rul. 91-49-011 (Aug. 30, 1991) (income of recycling program formed by certain municipalities exempt under section 115).

157. Priv. Ltr. Rul. 90-46-032 (Aug. 20, 1990) (medical center exempt from federal income tax because it was affiliated with a university that was a state instrumentality).

158. See Priv. Ltr. Rul. 95-49-030 (Sept. 11, 1995).

159. See Priv. Ltr. Rul. 96-24-013 (Mar. 15, 1996). In this ruling, status as an instrumentality was essential to the corporation's ability to issue tax-free bonds.

160. See Priv. Ltr. Rul. 94-35-031 (June 3, 1994).

161. See *supra* notes 104-109 and accompanying text.

162. Tests have been established for status as an instrumentality for section 414(d), which defines a gov-

there are questions about the appropriateness of the financial commitment test in testing under the “integral part” doctrine,¹⁶³ the overlap with the integral part doctrine as well as section 115 is itself appropriate and desirable. The overlapping tests reflect the close relationship between the integral part doctrine and section 115. The differences between these two doctrines should go to whether the governmental entity is treated as separate from the State; the substantive tests should not differ. Thus, if the tests for when an entity is treated as separate were clarified,¹⁶⁴ the tests for identifying an instrumentality would offer a basis for reconciling the currently inconsistent tests for integral parts and section 115 entities.

III. CASE STUDIES

The current tests for governmental affiliates form an inconsistent and confusing patchwork. For the integral part doctrine, no published guidance exists; the criteria must be gleaned from often inconsistent private revenue rulings.¹⁶⁵ Even when published revenue rulings exist, private rulings often apply different or additional tests. Entities of all categories—integral parts, section 115 entities, section 501(c)(3) organizations, and instrumentalities—are sometimes treated as separate, and other times not. Initial funding is a key consideration under the integral part doctrine, but for section 115, what happens to funds upon the entity’s dissolution determines eligibility. Disproportionate benefits to private parties prevent exemption under section 501(c)(3), and may also do so under section 115. Qualifying as an instrumentality does not qualify an entity for exemption, but tests for status as an instrumentality are sometimes used for purposes of excluding income under section 115.

The following case studies expose this confusion in three specific contexts. The history of the Michigan Education Trust reveals difficulties faced by the IRS and the federal courts in dealing with these issues. The saga of state disaster funds in California and Florida offers a critique of the financial commitment requirement under the integral part doctrine. At the same time that the IRS was ruling that disaster insurance funds in California and Florida qualified as integral parts of their states, it was challenging the exemption for the Texas fund insuring against Workers’ Compensation Act claims. That all three of these case studies attracted congressional attention demonstrates the importance of this area of the law. Moreover, the congressional response in the case of Workers’ Compensation Act Companies offers a model for regulations that would reduce confusion and inconsistency.

emmental plan for purposes of the tax rules applicable to pension plans as including a plan maintained by a governmental instrumentality. They differ somewhat from those established by Revenue Ruling 57-128 for the payroll tax provisions. The tests under section 414(d) are listed in Rev. Rul. 89-49, 1989-1 C.B. 117, and resemble those for integral part very closely. In addition to control over the organization’s everyday operations, Rev. Rul. 89-49 lists the following factors: “(1) whether there is specific legislation creating the organization; (2) the source of funds for the organization; (3) the manner in which the organization’s trustees or operating board are selected; and (4) whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit.” *Id.*

163. See *supra* Part II.B.

164. For further discussion and the suggestion of possible regulations see *infra* Part IV.

165. See BITTKER & LOKKEN, *supra* note 27. Unlike regulations and revenue rulings, private rulings are not reviewed by the Treasury’s Office of Tax Policy.

A. Michigan Education Trust

In the 1980s and 1990s, in response to concerns regarding the affordability of higher education, states enacted prepaid tuition plans.¹⁶⁶ In general, under these plans, an entity affiliated with the state government sells contracts, generally to parents or grandparents of children, invests the proceeds of the sales, and promises to pay the tuition of any beneficiary child who attends a public school in the state. The Michigan Education Trust was the first plan and a model for others. Its quest for tax-exemption, and the need for Congress to act to resolve the issue illustrate many of the problems with the current approach to the income tax treatment of government affiliates.

The Michigan Education Trust is organized as an autonomous subunit of the Michigan Treasury Department.¹⁶⁷ Subject to approval by the legislature, the Governor appoints its nine-member Board of Governors.¹⁶⁸ Its assets are not state property.¹⁶⁹ Funds it collects are not subject to the claims of state creditors, and if the trust were to become insolvent, any remaining assets are to be distributed to investors rather than go to the state.¹⁷⁰

The Michigan Education Trust sought a ruling that its income was exempt from income taxation as either an integral part or a section 115 entity. The IRS denied exemption on both bases.¹⁷¹ It rejected the argument that the trust was an integral part of the state. The ruling explained that the Trust was created as a corporation to operate independently from the state, that no state agency could override the decisions of the Trust's board of directors, and "funds are not derived from State X or one of its political subdivisions, and by statute are not subject to the claims of State X creditors and are not considered state money or common cash of the state."¹⁷²

The IRS also denied the Michigan Education Trust status as a section 115 entity. Under the accrual test, the trust did not qualify as a section 115 entity because upon dissolution its assets were to go to investors rather than the state.¹⁷³ The ruling, however, did not discuss the accrual test. The IRS ruling instead rested on a conclusion of impermissible private benefit. The ruling states:

To qualify under section 115, it must be established that the income does not serve private interests such as designated individuals, shareholders or organizations, or persons controlled, directly or indirectly, by such private interests. Thus, even if the income serves a public interest, the requirements of section 115 are not satisfied if the income also serves a private interest that is not incidental to the public interest. The basic principle underlying section 115 is that property (including any income thereon) must be devoted to purposes which

166. See Sheryl Stratton, *Prepaid Tuition Programs Major in Political Science*, 14 EXEMPT ORG. TAX REV. 221 (1996) (noting twelve states with prepaid college tuition plans).

167. See MICH. COMP. LAW. ANN. § 390.1425 (West 1988).

168. *Id.* § 390.1430(1).

169. *Id.* § 390.1429(2).

170. *Id.* § 390.1429(2)-.1437.

171. See Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).

172. *Id.*

173. See *Id.*

are considered beneficial to the community in general, rather than particular individuals.¹⁷⁴

The IRS concluded that because the trust provided its benefits to contract beneficiaries, it did not qualify under section 115.¹⁷⁵

The Michigan Education Trust ruling marks the first appearance of the private benefit test for purposes of section 115, and the weaknesses of the test are particularly evident in this context. Most public programs distribute their benefits unequally, and in this case, the benefits of the educational contract might well be more than incidental to the public interest.¹⁷⁶ The educational trust may save the state government money by helping citizens provide for the costs of education, thus reducing the need for state support. Moreover, education is a traditional and accepted government interest.

After being denied recognition as either an integral part or a section 115 entity, the trust applied for exempt status under section 501(c)(3). The IRS ruled that the trust did not so qualify. The trust then paid tax on investment income realized in its 1988 fiscal year and sued in federal court for refund of taxes assessed against income earned by the trust. On cross-motions for summary judgment, the district court agreed with the IRS that the trust was liable for taxes.¹⁷⁷ The district court also agreed with the IRS that the trust was not an integral part of the state.¹⁷⁸ The court also denied the trust status as a section 115 entity, but on the grounds that it failed the accrual requirement rather than on the grounds of excessive private benefit given by the IRS.¹⁷⁹ The district court further held that, because of the private benefit enjoyed by investors and beneficiaries, the trust did not qualify for exemption under section 501(c)(3).¹⁸⁰

On appeal, the Sixth Circuit reversed the district court 2-1.¹⁸¹ In treating the trust as exempt, the majority confused and misapplied the tests for political subdivision, instrumentality, and integral part. It first found the trust to be a political subdivision. It stated that because the trust was authorized to exercise contracting powers "on behalf of the state," it was empowered "to exercise governmental functions."¹⁸² Further, "the education trust would qualify as a 'political subdivision under the [section 103] regulations ... since, as 'a public body corporate and politic,' it is in a broad sense a 'municipal corporation.'"¹⁸³

As discussed above, however, status as a public body corporate and politic does not make an entity or its income exempt as a political subdivision.¹⁸⁴ The entity must exercise sovereign powers of eminent domain, taxation, or police power or be an integral part

174. *Id.*

175. Indeed, participants were expected to obtain better than market investment returns through the shelter of the Trust's expected exemption from federal tax as a governmental entity. See Aprill, *supra* note 7, at 492.

176. See *supra* notes 111-113 and accompanying text; *infra* note 200 and accompanying text.

177. *Michigan v. United States*, 802 F. Supp. 120, 127 (W.D. Mich. 1992) *rev'd*, 40 F.3d 817 (6th Cir. 1994).

178. See *id.* at 123.

179. See *id.* at 124.

180. *Id.*

181. See *Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994).

182. *Id.* at 825.

183. *Id.* at 825-26.

184. See *supra* notes 37-54 and accompanying text.

of a political subdivision.¹⁸⁵ The Sixth Circuit opinion ignored these crucial requirements regarding sovereign powers. The majority opinion emphasized repeatedly the status of the Michigan Education Trust as an instrumentality.¹⁸⁶ It discussed at length *Rose v. Long Island Railroad Pension Plan*,¹⁸⁷ which concluded that the railroad was an instrumentality of the Metropolitan Transportation Authority and that the Metropolitan Transportation Authority was itself a political subdivision. The Sixth Circuit then turned to the six factors listed in Revenue Ruling 57-128¹⁸⁸ and determined that the Michigan Education Trust qualified as an instrumentality of the state.¹⁸⁹

The Sixth Circuit, however, had to decide whether the trust was an integral part or a political subdivision of the state: that the trust was an instrumentality did not resolve the issue. *Rose*, in contrast, involved section 414(d), a provision that defines a governmental pension plan to include plans of instrumentalities as well as those of states and their political subdivisions.¹⁹⁰ Moreover, the Second Circuit in *Rose* was careful to use different tests to determine the status of the Metropolitan Transportation Authority as a political subdivision and that of the Long Island Railroad as its instrumentality.¹⁹¹ Indeed, it is the differences between an instrumentality on one hand, and a state or political subdivision of a state on the other, that required the IRS to develop the six factors of Revenue Ruling 57-128.¹⁹²

The Sixth Circuit erred in concluding that the Michigan Education Trust qualified as an instrumentality under Revenue Ruling 57-128. Under Revenue Ruling 57-128, the trust can qualify as an instrumentality only if the State, rather than private interests, had the powers and interests of an owner.¹⁹³ Such is not the case. The State of Michigan has no claim to MET's assets either during its existence or upon liquidation.

Having concluded that MET was a public instrumentality, the majority opinion compounded its error by also concluding that MET was an integral part of the state and that thus there was no need to decide whether it was a section 115 entity.¹⁹⁴ But, as discussed earlier, an instrumentality must be a separate entity and cannot be an integral part of the state.¹⁹⁵ The majority opinion failed to discuss whether the trust satisfied the criteria for ignoring structure as a body politic to treat an entity as an integral part.

The majority's reasoning suggests that all instrumentalities are integral parts of a political subdivision. This conclusion ignores the many provisions that distinguish states and their political subdivisions from instrumentalities and in some cases, such as under section 170, treat them differently.

185. See *supra* Part II.A.

186. *Michigan*, 40 F.3d at 825-27.

187. 828 F.2d 910 (2d Cir. 1987), *cert. denied* 485 U.S. 936 (1988).

188. See *supra* note 142 and accompanying text for a description of these six factors.

189. *Id.* at 917-18.

190. See *supra* note 162 for discussion of section 414(d).

191. See *Rose*, 828 F.2d at 916-18 (stating that to determine whether the MTA was a political subdivision the court looked to NLRB criteria and case law; the court based its conclusions that Long Island Railroad was an instrumentality on 29 U.S.C. § 1002(32)).

192. See Rev. Rul. 57-128, 1957-1 C.B. 311, 312.

193. *Id.*

194. See *Michigan*, 40 F.3d at 829.

195. See *supra* note 130 and accompanying text.

The majority opinion has been sharply criticized. The dissent points out many of the errors in the majority's reasoning as to the trust's status as a political subdivision, integral part, and instrumentality.¹⁹⁶ The IRS has also signaled its disapproval. Several private letter rulings describe the court's opinion as "internally inconsistent."¹⁹⁷ Commentators, including this author, have not hesitated to analyze its flaws.¹⁹⁸

Nonetheless, given the confusion in the IRS standards for the various categories of governmental and semi-governmental entities, the Sixth Circuit opinion is understandable. The IRS had no published criteria for integral part. The majority opinion in *Michigan* thus underscores the uncertain bounds of the category.¹⁹⁹ The opinion also identifies the key problem with any denial of exemption for a governmental entity based on private benefit: "It is true that the particular individuals who attend public colleges and universities in Michigan under the state's prepaid tuition program benefit directly from the program, while the rest of the citizenry benefits only indirectly. But much the same can be said of most governmental benefit programs...."²⁰⁰

The weaknesses in the Sixth Circuit opinion and the IRS unwillingness to accept its reasoning left the status of prepaid tuition plan and of pending rulings regarding such plans in doubt. Congress decided it was "appropriate to clarify the tax treatment of State-sponsored prepaid tuition and educational savings programs in order to encourage persons to save to meet post-secondary educational expenses."²⁰¹ Thus, as part of the Small Business Act of 1996, Congress enacted section 529, which provides that the earnings of qualified state tuition programs established and maintained by a state (or agency or instrumentality thereof) are not currently taxable, but will be taxed to the beneficiary only when distributions are made from the account.²⁰²

The uncertainties about the status of prepaid tuition plans as governmental entities forced Congress to act. Reliance on congressional action, however, is not a satisfactory

196. See *Michigan*, 40 F.3d at 832-35.

197. See, e.g., Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996); see also Priv. Ltr. Rul. 96-27-106 (Apr. 5, 1996). This ruling explains that the court opinion is inconsistent because "it concludes that [the trust] qualifies as a political subdivision ... , that [the trust] is 'in a broad sense' a municipal corporation ... , and that [the trust] is in any event an integral part of the State of Michigan." *Id.* This ruling criticizes the reliance on the factors of Rev. Rul. 57-128 because the factors "do not determine whether an enterprise is considered to be a separate entity or an integral part of the State." *Id.*

198. See Ellen P. Aprill, *More Outrage at Michigan Education Trust Decision*, 66 TAX NOTES 121 (1995); see also Lee A. Sheppard, *State Tax Immunity and Middle-Class Entitlements*, 65 TAX NOTES 1317 (1994).

199. For example, according to a General Accounting Office study, the IRS was willing to grant a tuition program status as an integral part only if it had the full faith and credit of the state. Of the state tuition plans, only Florida satisfied this requirement. See GENERAL ACCOUNTING OFFICE, COLLEGE SAVINGS: INFORMATION ON STATE TUITION PREPAYMENT PROGRAMS (GAO/HEHS-95-131) (Aug. 1995), available in LEXIS, Fedtax Library, TNT File, 95 TNT 167-16. The basis on which the IRS would make this conclusion is uncertain. Is full faith and credit for the plan's obligations the necessary financial commitment? Is it the only possible kind of financial commitment?

200. *Michigan*, 40 F.3d at 829.

201. JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS, JCS-12-96 (Joint Committee Print December 18, 1996), available in LEXIS, Fedtax Library, TNT File, 96 TNT 246-8.

202. I.R.C. § 529(b)(3) (1997) (added by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1806(a), 110 Stat. 1895 (1996)).

answer to the problem of uncertain standards. It is difficult and expensive for Congress to act.²⁰³ Congress granted exemption to tuition plans that satisfy a variety of conditions, but these conditions, such as a prohibition on contributors or beneficiaries directing investments, a requirement that separate accounts be kept for each beneficiary, or a requirement imposing more than *de minimis* penalties upon refund,²⁰⁴ do not apply readily to other kinds of governmental affiliates. Congress exempted tuition plans as an incentive for higher education, not because of their status as governmental entities. The Taxpayer Relief Act of 1997, for example, extended the exemption for qualified tuition programs beyond state colleges and universities to certain accredited post-secondary educational institutions.²⁰⁵ The saga of the Michigan Education Trust illustrates the problems of current standards regarding governmental affiliates. However, it does not provide a model for reform because its resolution involves educational entities, whether public or private, rather than governmental entities.

B. State Disaster Funds

From time to time, citizens of particular states have difficulties finding affordable insurance of one type or another.²⁰⁶ States respond to these insurance crises in a variety of ways. Sometimes they mandate by statute or regulation that insurers in their state offer a particular kind of coverage.²⁰⁷ At other times, the state itself sets up an insurance fund.²⁰⁸ Recently, both Florida²⁰⁹ and California²¹⁰ established state disaster funds and sought exemption for them as integral parts of the state. The history of these rulings, especially the numerous IRS changes of position regarding the California fund, highlight

203. See generally GUIDO CALEBRESI, *A COMMON LAW FOR THE AGE OF STATUTES* (1982); cf. William N. Eskridge, Jr., *Overriding Supreme Court Statutory Interpretation Decisions*, 101 YALE L. J. 331 (1991); James J. Brudney, *Congressional Commentary on Judicial Interpretations of Statutes: Idle Chatter or Telling Responses*, 93 MICH. L. REV. 1, 2-32 (1994).

204. See I.R.C. § 529(b)(3)-(5) (1994).

205. Section 211(b)(2) of the Taxpayer Relief Act of 1997, H.R. 2014, P.L. 105-34, adding Section 529(e)(5). Eligible institutions are those described in the Higher Education Act of 1965, 20 U.S.C. 1088, and eligible to participate in a program under title IV of that act. *Id.* Those eligible include certain "proprietary and post-secondary vocational institutions." Conference Report Explanation for H.R. 2014, Tax Notes Today, available in Lexis, FedTax library, TNT File, 97 TNT 171-52.

206. A search of "insurance crisis" in LEXIS, News Library, Current News file for 1996 and 1997 produced over 500 documents.

207. California, for example, has long required insurers that sell homeowners insurance to offer earthquake insurance. CAL. INS. CODE § 10081 (1997).

208. The California and Florida case studies that follow are examples.

209. See Priv. Ltr. Rul. 95-22-039 (Mar. 6, 1995); Priv. Ltr. Rul. 95-07-037 (Nov. 21, 1994). See also Meegan M. Reilly, *Buildings on a Fault Line: States and the Instrumentality Tax Break*, 71 TAX NOTES 1151, 1153 (1996).

210. See Priv. Ltr. Rul. 97-06-006 (Nov. 8, 1996); Priv. Ltr. Rul. 96-41-010 (June 25, 1996); Priv. Ltr. Rul. 96-31-011 (Apr. 30, 1996); Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996). See also Service Releases Letter *Withdrawing Approval of California Earthquake Authority*, TAX NOTES TODAY, Aug. 5, 1996, available in LEXIS, Fedtax Library, TNT File, 96 TNT 152-38; *California Earthquake Authority Ruling Reapproved Without Change*, TAX NOTES TODAY, July 2, 1996, available in LEXIS, Fedtax Library, TNT File, 96 TNT 129-5; *IRS Withdraws Exemption to California Earthquake Authority*, TAX NOTES TODAY, May 15, 1996, available in LEXIS, Fedtax Library, TNT File, 96 TNT 96-89. Because California released these rulings, more detailed information, including dollar amounts, is available than if only the retracted versions were available.

the uncertain reach of the financial commitment requirement for status as an integral part of a state or political subdivision.²¹¹

When Florida submitted its initial ruling request, state law authorized the hurricane disaster fund to receive funding through various sources.²¹² Such sources included reinsurance premiums from insurers participating in the Fund, assessments on insurers writing other types of coverage, and state appropriations.²¹³ In ruling that the state had a financial interest in the Fund and that the Fund thus was an integral part of the state, the IRS emphasized the assessments on non-participants.²¹⁴

By assessing the Non-Participant, the State has effectively exercised its power to collect revenue and appropriate such moneys to the Fund. In relation to the other sources of moneys and the type of operations of the Fund, this contribution of state moneys, raised through its exercise of state power to collect payments by Non-Participants, is significant.²¹⁵

The Florida legislation did not pass as proposed. Most significantly, in the enacted legislation, assessments on non-participants was replaced with additional appropriations from the General Revenue Fund and from the Regulatory Trust Fund.²¹⁶ The Regulatory Trust Fund collects fines, penalties, and license fees paid by a broad range of regulated persons.²¹⁷ The IRS concluded that these changes did not affect the Fund's status as an integral part of the state.²¹⁸

California took a different approach to funding its earthquake fund. The original statute permitted a variety of funding. The primary proposed source of funding was to have been actuarially determined premiums from homeowners buying insurance through the fund.²¹⁹ The second source was assessments on insurers choosing to satisfy their statutory obligation to offer earthquake insurance by selling the Fund's policies to their customers.²²⁰ In addition, the State would contribute to the Fund a "premium tax equivalent"—an amount equal to the state's premium tax on all insurance policies—charged to the fund's policyholders. The statute authorized the State Treasurer to issue

211. In neither case was state control an issue; both funds were operated under boards of state officials. See Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996); Priv. Ltr. Rul. 95-07-037 (Nov. 21, 1994). These rulings also demonstrate that the separate identity of an entity that would be a per se corporation in two ways under the new check-the-box regulations—as an insurance company and as a business entity wholly owned by the State—will be ignored when the entity is deemed an integral part. See *supra* notes 79-82 and accompanying text.

212. Priv. Ltr. Rul. 95-07-037 (Nov. 21, 1994) (describing FLA. STAT. ch. 215.555 (1994) and the proposed amendments).

213. The statute also authorized local governments to issue revenue bonds for the benefit of the Fund; such internal revenue bonds would not be backed by the full faith and credit of the State, but would be paid only from Fund revenues. See FLA STAT. CH. 215.555 (1994).

214. Priv. Ltr. Rul. 95-07-037 (Nov. 21, 1996).

215. *Id.*

216. FLA. STAT. ch. 215.555 (1995).

217. *Id.*

218. Priv. Ltr. Rul. 95-22-039 (Mar. 6, 1995).

219. CAL. INS. CODE § 10089.40 (1995).

220. See CAL. INS. CODE § 10089.23 (1995). A participating insurer would be prohibited from also offering its own earthquake insurance.

debt obligations if these and other sources of funds proved inadequate to cover claims, but the statute provided that the state had no liability on these obligations.²²¹

The enabling legislation for the California Earthquake Authority required it to receive federal tax-exempt status.²²² A great deal of political pressure accompanied the original ruling request for the California Earthquake Authority. California Insurance Commissioner Quackenbush was reported to have stated, "I began to apply political pressure to the IRS even though I was told it was a cardinal sin," and that he contacted White House Chief of Staff Leon Panetta and Senator Dianne Feinstein. Quackenbush is reported to have continued, "It all came down to California having 54 electoral votes, and we were headed to an insurance meltdown that I was not going to take the blame for."²²³ In October 1995, Senator Dianne Feinstein wrote to Secretary of Treasury Rubin urging him to grant the exemption.²²⁴

The IRS initially granted a favorable ruling on the earthquake fund.²²⁵ The ruling emphasized the premium tax equivalent.²²⁶ It explained that dedicating the premium tax to the fund "is substantially the same in this case as if [the] State had collected the premium tax and contributed the full amount of that premium tax directly to the Fund."²²⁷ The ruling, however, went on to make some extraordinary arguments that it claimed further supported treating the fund as an integral part of the state. It explained that Fund coverage would help the citizens of the state recover from the catastrophic effects of an earthquake; that the state-wide private market for earthquake insurance was in crisis, which was hurting its citizens; and that the creation of the fund "represents a significant exercise of State's power to regulate the state insurance industry."²²⁸

However accurate these points may be as criteria, they represent an unprecedented expansion of the category of an integral part, an expansion much like that implied by the Sixth Circuit's opinion in *Michigan v. United States*. Such an expansion is unwarranted and inconsistent with other IRS rulings. Exercise of regulatory power by a state is not an exercise of police power, and does not result in exemption from federal tax for the regulated industry. Regulated entities do not become integral parts of the state.

In Technical Advice Memorandum 93-47-001, for example, as in California, the state viewed unavailability of a certain kind of liability insurance from commercial insurers as a crisis and "a threat to public health, safety and welfare" as well as a "threat to the economic welfare" of the state.²²⁹ The state passed legislation establishing a tempo-

221. CAL. INS. CODE § 10089.29 (1995).

222. CAL. INS. CODE § 10089.14 (1995); see also *Senator Feinstein Wants Tax Exemption for State Earthquake Authority*, TAX NOTES TODAY, Nov. 9, 1995, available in LEXIS, Fedtax Library, TNT file, 95 TNT 220-28 [hereinafter *Senator Feinstein Wants Tax Exemption*].

223. See Reilly, *supra* note 209, at 1153.

224. *Id.*

225. California announced the favorable ruling on Feb. 27, 1996. *Advance Copy of the IRS Ruling That Earthquake Insurance Fund is Integral Part of California*, TAX NOTES TODAY March 5, 1996, available in LEXIS, Fedtax Library, TNT File, 96 TNT 45-22 [hereinafter *Advance Copy of the IRS Ruling*].

226. The premium tax equivalent was expected to amount to \$23.5 million annually. See Reilly, *supra* note 209.

227. *Id.*

228. Priv. Ltr. Rul. 96-22-019 (May 31, 1996).

229. Tech. Adv. Mem. 93-47-001 (July 26, 1993).

rary, non-exclusive joint underwriting association.²³⁰ It required every insurer writing a particular type of insurance to join the association and to offer the insurance against liability for mine subsidence needed by businesses in the state.²³¹ The rates charged for the insurance were to be self-supporting.²³²

Thus the association satisfied all the additional factors listed in the California Earthquake Authority ruling. The association, however, did not qualify as an integral part of the state because the state neither supplied it with funds nor exercised control over it.²³³ Similarly, a fund required by state law to provide insurance against mine subsidence was deemed not to be an integral part of the state even though it was subject to the supervisory control of the State Director of Insurance and even though it received state financial support, because private parties had operational control and the state financial support was limited in amount and duration.²³⁴

In April 1996, perhaps because of the language concerning regulatory power, the IRS withdrew without explanation the favorable ruling granted the California Earthquake Authority without explanation.²³⁵ More political pressure followed. The House Appropriations Committee took note of the ruling recognizing the exempt status of the California Earthquake Authority, and of the ruling's withdrawal, and urged the IRS to expeditiously resolve "this very important issue."²³⁶ The ruling was reapproved within a few days of the publication of this report.²³⁷ The reapproved ruling made no changes to the original, not even to the language suggesting that regulated entities might be considered integral parts of states or political subdivisions.²³⁸

In the brief period between withdrawal of the ruling and its reapproval, an aide to the chair of the California Assembly's Insurance Committee speculated that a broad-based assessment, such as the one in Florida's hurricane disaster fund, would have helped the California Earthquake Fund.²³⁹ This speculation underscores the uncertainty in the financial commitment test. The IRS has never made clear what commitment is neces-

230. *Id.*

231. *Id.*

232. *Id.*

233. *Id.*

234. Gen. Couns. Mem. 39,006 (Apr. 28, 1983).

235. Priv. Ltr. Rul. 96-31-011 (Apr. 30, 1996).

236. *IRS-Related Excerpts of House Report on FY 1997 Treasury-Postal Appropriation*, TAX NOTES TODAY, June 28, 1996, available in LEXIS, Fedtax Library, TNT File, 96 TNT 127-17 (excerpting the House Appropriation Committee's report on the 1997 Treasury, Postal Service, and General Government Appropriations Bill).

237. See Priv. Ltr. Rul. 96-41-010 (June 25, 1996).

238. *Id.* The saga, however, did not end with reapproval of the original ruling. After the legislature enacted amendments to the California Earthquake Authority's authorizing statute, the IRS issued a ruling that, as amended, the fund remained an integral part of the state. See Priv. Ltr. Rul. 97-06-006 (Nov. 8, 1996). There were no significant changes in the later ruling's analysis and conclusion. These sections of the ruling added reference to regulations of the fund's employees concerning financial disclosure, civil service, and post-government employment as well as the fact that, under the revised statute, the state would contribute only part, not all, and loan an additional part of the fund that had been terminated. *Id.*

239. See Reilly, *supra* note 209. For another example of state-provided insurance funded by broad-based assessment, see Priv. Ltr. Rul. 96-27-016 (Apr. 5, 1996), in which the IRS ruled that an insurance fund was an integral part of the state and pointed to a special mortgage fee as well as the potential to assess insurance policies for property not insurable by event coverage.

sary—whether revenues from the state's general fund or other tax revenues must be at risk and if so, to what extent.

Many questions remain unanswered. Must the state have amounts at risk in funding the venture or is it sufficient to have general revenues used for shortfalls? Must creditors of the state have access to the entity's funds? Is there an absolute dollar amount that is sufficient or is some kind of percentage of the venture amount required? Is the required commitment to the initial capital of the endeavor or must it be ongoing? Is payment of employee salaries sufficient to satisfy the financial commitment requirement? In the case of the California Earthquake Authority, for example, annual premiums for the earthquake insurance were estimated at \$985 million to \$1.2 billion, the initial assessment on participants at \$1 billion, and the premium tax equivalent was estimated at \$23.5 million.²⁴⁰

In addition to raising questions about the financial commitment requirement, these disaster fund rulings underscore the problematic relationship between the integral part doctrine and section 115. The rulings involving both the Florida and California disaster funds mention that upon dissolution, all of the fund's assets were to go to the State after payment of claims and expenses.²⁴¹ That is, both funds would satisfy the accrual requirement as it has been interpreted for purposes of section 115.²⁴² Neither ruling, however, indicates whether that fact is important to the conclusion, leaving uncertain whether the dissolution requirement applies to both section 115 entities and integral parts.

Moreover, neither the California nor the Florida disaster funds, which qualify as integral parts, would qualify as section 115 entities under the current ruling standards. Both funds benefit private parties. Private Letter Ruling 93-47-001, for example, rejected status as a section 115 entity or as an integral part for a joint underwriting association. The ruling contrasted the provision of "commercial-type insurance for private entrepreneurs" to the situation in Revenue Ruling 90-74, where an insurance fund covered the risks of political subdivisions rather than private citizens and thus "private interests do not participate in the organization or benefit more than incidentally from the organization."²⁴³ Under such reasoning, the Florida and California disaster funds, although qualified as integral parts, would not qualify under section 115 if they had chosen to be treated as separate.²⁴⁴ Their very purpose is to benefit private parties.

The creation of the disaster funds in California and Florida, however, was clearly an exercise of the states' sovereignty and police power. That such funds could not qualify under section 115, but did qualify as integral parts, demonstrates again the need for clearer and more consistent standards across, and not just within, the categories of governmental affiliates.

240. See *Advance Copy of the IRS Ruling*, *supra* note 225.

241. See Priv. Ltr. Rul. 95-07-037 (Nov. 21, 1994) (Florida); Priv. Ltr. Rul. 93-47-001 (July 26, 1993) (California).

242. See *supra* note 104 (discussing section 115's accrual requirement).

243. Priv. Ltr. Rul. 93-47-001 (July 26, 1993).

244. One commentator has suggested that an insurance company, even if an integral part of a state or political subdivision, must be treated as separate for purposes of filing an income tax return. See Simpson, *supra* note 54, at A50.

C. State Workers' Compensation Act Companies

Tax treatment of state-sponsored insurance companies has proved to be a problem in areas other than disaster funds. In many states, an entity affiliated with the government offers workers' compensation insurance to all private employers in the state. They supply this insurance for much the same reason as Florida and California established their disaster funds, a perceived crisis in the private market for such insurance.²⁴⁵ Congress recently acted to exempt certain state workers' compensation insurers.²⁴⁶ The congressional criteria for exemption offer a useful model for developing regulations applicable to governmental affiliates.

Prior to congressional action, according to the legislative history, workers' compensation funds sought exemption in a variety of ways. Some funds qualified for exemption under section 501(c)(6), which exempts business leagues, chambers of commerce, real estate boards, and boards of trade.²⁴⁷ To qualify, organizations must assign any insurance policies and administrative functions to their member organizations and must be financed, at least in part, by membership dues.²⁴⁸ Others qualified as exempt under section 501(c)(4), which applies to social welfare organizations. Others assumed they qualified for exemption of their income under section 115 because they saw themselves as serving an essential governmental function.²⁴⁹ In recent years, however, the IRS has challenged the exemption for some of these workers' compensation fund entities. In June of 1997, for example, Governor George Bush of Texas wrote Senator Phil Gramm to express his concern about the Internal Revenue Service "questioning the source of the Texas Workers' Compensation Insurance Fund's tax exemption."²⁵⁰

All the possible sources for exemption of such funds are open to question. The funds may not be satisfying the condition for exemption under section 501(c)(6).²⁵¹ Since the Tax Reform Act of 1986,²⁵² section 501(m) has prohibited exemption for entities providing commercial-type insurance as a substantial part of their activities, and that prohibition renders qualification for exemption under section 501(c)(4) difficult.²⁵³ Satisfying the requirements for exemption under section 115 has also become uncertain. The IRS in both published and private rulings requires that section 115 entities provide only incidental private benefit.²⁵⁴ Because private employers and not just municipal employers benefit from the insurance provided by workers' compensation funds, they would not qualify under the current IRS standards for section 115.

245. See 143 Cong. Rec. S 6703 (June 27, 1997) (letter from Texas Governor George W. Bush to Texas Senator Phil Gramm, discussing perceived workers' compensation insurance crisis.)

246. Somewhat surprisingly, the category is named "Workmen's Compensation Act Companies" instead of "Workers' Compensation Act Companies." I.R.C. § 501(c)(27). This Article uses the gender neutral term, as do many states.

247. See I.R.C. § 501(c)(6) (1997).

248. CONFERENCE REPORT EXPLANATION FOR H.R. 2014, TAX NOTES TODAY, available in LEXIS, Fed-tax Library, TNT File, 97 TNT 171-59.

249. *Id.*

250. 143 Cong. Rec. S 6703.

251. See *supra* notes 247-248 and accompanying text.

252. Pub. Law. No. 99-5141 (adding section 501(m)).

253. See CONFERENCE REPORT, *supra* note 248.

254. See *supra* notes 108-109 and accompanying text.

In 1996 and 1997 Congress acted to eliminate the uncertainty regarding the exemption of workers' compensation plans. In 1996 it enacted section 501(c)(27) to exempt state worker's compensation reinsurance associations established before June 1, 1996.²⁵⁵ In 1997, it amended the provision to permit exemption for new workers' compensation funds, provided the funds satisfy a variety of requirements.²⁵⁶ Some of the statutory conditions are tailored to workers' compensation fund entities. State law must require such insurance or provide "significant disincentives" if employers do not purchase it.²⁵⁷ Also, the organization must provide such insurance to any employer in the state.²⁵⁸

Four of the requirements are more general structural requirements. First, they must be created by state law.²⁵⁹ Second, an executive branch official of the state, the state legislature or both must appoint the majority of the fund's oversight board.²⁶⁰ Third, if state law permits the organization to dissolve, its assets must revert to the state upon its dissolution.²⁶¹ Fourth, the state must make a financial commitment to the fund either by extending its full faith and credit to the fund's initial debt or by providing its initial operating capital.²⁶² The House Report offers two examples of ways to satisfy the requirement of providing initial operating capital: "the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority," or "the bonds may be repaid through exercise of the State's taxing authority."²⁶³

In light of the diverse requirements established in IRS rulings for the respective categories of government affiliates, the structural requirements chosen by Congress for qualification under section 501(c)(27) are illuminating. The requirements pertaining to creation by state law, appointment of oversight board, reversion of assets upon dissolution, and provision of initial capital adopt in part current tests for integral part and in part the current tests for section 115 entities. Control of the governing board and financial commitment are keys to satisfying the integral part test. Any entity that satisfied the requirements of section 501(c)(27) could, like the California and Florida disaster funds, satisfy the integral part test. Reversion to the state upon dissolution parallels the IRS interpretation of accrual under section 115.

These tests of section 501(c)(27) also echo the most important tests for instrumentality. The section 501(c)(27) requirement that an entity be established by state law parallels the Revenue Ruling 57-128²⁶⁴ requirement that express or implied statutory or

255. Pub. Law. No. 104-191 § 342.6 (adding section 501(c)(27)).

256. Taxpayer Relief Act of 1997, H.R. 2014, Pub. Law. No. 105-34, § 963(a) codified at 501(c)(27) (1997). The Conference Report on the provision specifies, "No inference is intended that the organizations described in the provision are not exempt from tax under current law." See CONFERENCE REPORT, *supra* note 248. Although the statute by its terms is prospective, a colloquy in the Senate indicates some desire to apply the standards retroactively. 143 CONG. REC. S6703 (June 27, 1997).

257. I.R.C. § 501(c)(27)(B)(i)(I) (1997).

258. I.R.C. § 501(c)(27)(B)(ii). There can be reasonable requirements for providing such insurance to the employer. *Id.*

259. I.R.C. § 501(c)(27)(B)(i) (1997).

260. I.R.C. § 501(c)(27)(B)(iv) (1997).

261. I.R.C. § 501(c)(27)(B)(iii)(II) (1997).

262. I.R.C. § 501(c)(27)(B)(iii)(I) (1997).

263. H.R. 2014, 105th Cong. (as released on June 18, 1997), reprinted in CCH, Taxpayer Relief Act of 1997, Law and Explanation 1101, 1154-55.

264. See *supra* note 142.

other authority create the entity.²⁶⁵ The section 501(c)(27) requirement regarding destination of assets upon dissolution is an important aspect of the requirement under Revenue Ruling 57-128 that a state or political subdivision have the powers and interests of an owner over an instrumentality.²⁶⁶ The section 501(c)(27) requirement regarding financial commitment corresponds to the criteria under Revenue Ruling 57-128 regarding the degree of the organization's financial autonomy and source of its operating expenses. The tests under section 501(c)(27), however, are fewer in number, more specific, and easier to apply than those for instrumentalities under Revenue Ruling 57-128.

Equally significant is that which is absent from the requirements for exemption under section 501(c)(27). Unlike the requirements established by the IRS in rulings under section 115, there is no requirement that the entity provide only limited private benefits to qualify for exemption or that the entity save or make money for the state. Thus, under section 501(c)(27), the fund can charge fees equal to its costs. Section 501(c)(27), unlike Revenue Ruling 57-128 which provides criteria for instrumentalities, does not ask whether the entity has a governmental purpose or perform a governmental function.

While the requirements for exemption under section 501(c)(27) reflect the requirements for exemption as an integral part and for qualifying as an instrumentality, the section 501(c)(27) tests offer the benefit of greater specificity and certainty. Section 501(c)(27) more clearly defines the nature of the entity's authority, the required control, and the extent of financial commitment than do the published and private rulings applicable to integral parts, section 115 entities, and instrumentalities. Under section 501(c)(27), the authority creating the entity must be express; control must be exercised by appointing a majority of the board of oversight; and financial commitment extends to initial operating capital. Thus, the statutory requirements for section 501(c)(27) provide a model for regulations applicable to all categories of governmental affiliates.

IV. RECOMMENDATIONS

The four requirements of section 501(c)(27) regarding creation, control, initial financial commitment, and destination of assets upon dissolution embody the most important requirements underlying exemption for integral parts, section 115 entities, and instrumentalities.²⁶⁷ Such requirements should be promulgated as regulations under sections 115, 7701, and perhaps 3121.²⁶⁸ These four conditions could—and should—apply to all governmental affiliates seeking exemption from federal income tax.

Under the first requirement, an entity would be exempt only if it was created pursuant to the express authority of a state or political subdivision. In the case of section 501(c)(27) entities, the Internal Revenue Code requires that the authority establishing the

265. Rev. Rul. 57-128, 1957-1 C.B. 311. *See supra* note 142.

266. *Id.*

267. By fulfilling these criteria, the California and Florida disaster funds could qualify either as integral parts or as section 115 entities. In some situations, such as pre-paid tuition plans, these criteria would not support an exemption. In such cases, it is necessary and appropriate that Congress decide whether the entity should be exempt.

268. Section 115, of course, deals with section 115 entities. Section 3121 involves payroll taxes. Instrumentalities are exempt from certain of these taxes, and most instrumentality rulings involve section 3121. The regulations under section 7701 distinguish entities treated as separate from their owner and those that are not.

entity be state law.²⁶⁹ Given the variety of political subdivisions, express regulatory authority should also be sufficient. The second requirement would establish governmental control. The state or political subdivision must be able to appoint the majority of the entity's board. Either legislative bodies, executive officers, or both, could make these appointments. The third condition specifies the required financial commitment. The state or political subdivision must supply initial operating capital, or extend full faith and credit to the entity's debt. The fourth and final requirement considers the ultimate destination of funds. They must revert to the state or political subdivision upon dissolution.

Taken together, these requirements give the state or political subdivision the powers and interests of an owner. At the same time, they offer sufficient flexibility and clarity. The requirements recognize the sovereign power of state and political subdivisions to distribute benefits to their citizens. They distinguish entities that operate as agents of the government from those that operate directly for the benefit of private parties.²⁷⁰ They also eliminate criteria inappropriate for governmental entities, such as the weighing of private and public benefit. Finally, they give the deference that is due to states and their political subdivisions in our federalist system of dual sovereigns.

These requirements are appropriate for integral parts, section 115 entities, and instrumentalities. Such regulations would solve many of the current problems under section 115. These tests are workable for entities controlled by a single state or political subdivision. They are also workable for the various political subdivisions that constitute many of the section 115 rulings. Such a set of requirements, for example, would permit the exemption of a variety of state-run insurance companies, and would also avoid some of the current problems regarding state-run insurance funds. If the state establishes these companies, their exemption will not undermine section 501(m). The state will have determined that if the market is not operating adequately, they will not provide commercial-type insurance. As Justice Powell once wrote in a dissenting opinion, a "State frequently will respond to market conditions on the basis of political rather than economic concerns . . . , [therefore] it is a pretense to equate the State with a private economic actor."²⁷¹ This new set of requirements would eliminate the troublesome weighing of public and private benefit that casts doubt on the qualification of many entities that have assumed themselves exempt under section 115, particularly state-sponsored insurance funds.

The four requirements given above can and should also apply to the determination of whether an entity is exempt from federal income tax as an integral part of a state or political subdivision. As the examples of California and Florida show, under current law states can establish exempt insurance funds benefiting private parties if the insurance fund qualifies as an integral part of the state.²⁷² Currently the tests for integral part and section 115 lead to quite different results for similar kinds of organizations. Given the

269. See section 501(c)(27)(B)(i) (requiring creation, organization, and operation under state law).

270. Of course, a large body of literature argues that legislation is most accurately viewed as the product of a bargain between special interest groups and the legislature. The classic article making this argument is George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). See generally DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE* (1991). Discussion of such arguments is beyond the scope of this more doctrinal examination.

271. *Reeves, Inc. v. Stake*, 447 U.S. 429, 450 (1980) (Powell, J., dissenting).

272. See *supra* Part III.B.

close relationship between the integral part doctrine and section 115, the same tests should apply to both. Using these requirements will not only achieve consistency in treatment of integral parts and section 115 entities, but also will articulate with greater precision the test of control and financial commitment that the IRS currently applies under the integral part doctrine.

Because of the close relationship between integral parts and section 115, the state should be free to choose whether to treat an entity as integral or separate, provided the entity satisfies the four tests of creation, control, source of initial funds, and destination of funds upon dissolution. Just as business entities are explicitly given the option of separate treatment under the recent check-the-box regulations, so should the entities controlled by states and their political subdivisions. The IRS should explicitly permit state and political subdivisions the choice of treating entities that satisfy the four-fold test to be treated as either an exempt integral part or a separate entity exempt under section 115(1).

Finally, the same four requirements thus should apply to instrumentalities as well. The four requirements closely resemble those already announced in revenue rulings as applicable to instrumentalities. Adoption of these four tests would refine the current tests, make them easier to apply, and achieve consistency of treatment with other governmental affiliates.

The tests based on section 501(c)(27) and outlined above offer greater certainty than the many current tests. States and their political subdivisions should not be forced to rely on the uncertain and sometimes inconsistent results of the private ruling process. Their application should be certain as well. Thus, these criteria should be incorporated into regulations under section 115. They should also be promulgated as an amendment to the regulations under section 7701 in order to give states and political subdivisions the option of treating an affiliate as an exempt integral or as a separate entity. Finally, regulations under section 3121 and section 414 should adopt these tests for defining an instrumentality.

In arguing that the IRS and the Treasury should promulgate regulations in this area, I take a position different from one I took several years ago. In a 1992 article urging Congress to revisit and clarify section 115, I wrote, "In the delicate area of federal and state comity, Congress has a special, perhaps constitutional, responsibility to make decisions deliberately and express them clearly. It should not inadvertently and ambiguously delegate broad discretion to administrative agencies such as the IRS."²⁷³ I now believe that regulations promulgated by the Treasury and the IRS would be preferable to legislative action by Congress.²⁷⁴

The experience of the past several years counsels this change of position. Despite several pleas,²⁷⁵ Congress has not been willing to revisit the taxation of governmental affiliates. Instead, it has acted only when specific kinds of entities, such as prepaid tuition

273. See Aprill, *supra* note 7, at 423-24.

274. Both the IRS and the Department of Treasury participate in the drafting of regulations. See BITTKER & LOKKEN, *supra* note 27; MICHAEL I. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶ 3.02 (2d ed. 1991 and Supp. 1993); Mitchell Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity*, 43 TAXES 756 (1965); Paul F. Schmid, *The Tax Regulations Making Process - Then and Now*, 24 TAX. LAW. 541 (1971).

275. See Aprill, *supra* note 7; Sheppard *supra* note 198; Aprill *supra* note 198.

programs or Workers' Compensation Act Companies, have become embroiled in controversy.

In retrospect, Congress's unwillingness to act is not surprising. It is always difficult to get Congress to act.²⁷⁶ Here, the very sensitivity of federal-state relations may render congressional action particularly difficult.²⁷⁷ Thus, in the case of federal income tax treatment of governmental affiliates, the insulation of the IRS and Treasury from direct partisan politics may enable the administrative agency to act more easily than can Congress.²⁷⁸

Moreover, the IRS has not avoided and cannot avoid acting in this area of the law. Every year, it makes dozens of decisions as to the tax status of government affiliates in requests to ruling requests. Acting pursuant to regulations, however, would benefit both the IRS and governmental affiliates seeking rulings. By developing regulations through notice and comment rulemaking, the IRS would learn about and be able to consider the concerns and suggestions of states and political subdivisions.²⁷⁹ Greater certainty as to criteria for exemption would aid states and political subdivisions in planning and structuring related entities. By incorporating standards for exemptions into regulations to which courts defer,²⁸⁰ the IRS could forestall the need for either Congressional action or judicial challenge in many future cases.

Most importantly, as this Article has argued, promulgating regulations that adopt the same tests for integral parts, section 115 entities, and instrumentalities would bring consistency and rationality to this area of law. Congress has shown a way to reconcile the various tests for exempting states and political subdivisions by including in section 501(c)(27) tests as to creation, control, financial commitment, and destination of assets upon dissolution. The IRS should follow this lead and promulgate regulations applying these four tests to integral parts, section 115 entities and instrumentalities.

276. See *supra* note 203.

277. For arguments that the national political process does not adequately protect states as states, see Carol F. Lee, *The Political Safeguards of Federalism? Congressional Response to Supreme Court Decisions on State and Local Liability*, 20 URB. LAW. 301, 334-35 (1988); Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1491-93 (1987) (book review); Andrzej Rapaczynski, *From Sovereignty to Process: The Jurisprudence of Federalism After Garcia*, 1985 SUP. CT. REV. 341, 346-80.

278. See generally Jerry L. Mashaw, *Prodelegation: Why Administrators Should Make Political Decisions*, 1 J.L. ECON. & ORGANIZATION 81, 91-95 (1985) (illustrating that administrative agencies making political decisions have an undisputed efficiency advantage).

279. For the importance and usefulness of notice and comment rulemaking, see Michael Asimow, *Non-legislative Rulemaking and Regulatory Reform*, 1985 DUKE L.J. 381, 402-03; William T. Mayton, *A Concept of a Rule and the "Substantial Impact" Test in Rulemaking*, 33 EMORY L.J. 889, 896-99 (1984).

280. See Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX. REV. 51, 57-61 (1996).