

Availability of Federal Income Tax Exclusion in IRC § 115 for Government Risk Pools That Include Nonprofit Corporations Pursuant to RCW Chapter 48.62

Overview of Legal Advice to OFM

1. IRC § 115 in General.

IRC § 115 exempts from federal income tax income “derived from *** the exercise of any essential governmental function and accruing to a State or any political subdivision thereof ***.” IRC § 115 is the main provision in the Internal Revenue Code that protects incorporated governmental risk pools from income tax liability. Risk pools that are mere unincorporated divisions of government, or that are formed as partnerships or other legal entities, are subject to other tax analysis.

2. Requirements of IRC § 115.

The IRS has interpreted IRC § 115 in the context of risk pools in one key 1990 revenue ruling (Rev Rul 90-74), as well as numerous private letter rulings (“PLRs”) that have been sought by risk pools. These rulings establish the following requirements for the exemption to apply:

- The entity must exercise an “essential governmental function.” The pooling of casualty risks generally satisfies this requirement because it fulfills a political subdivision’s obligation to protect its financial integrity.
- The income of the entity must “accrue to” a state or political subdivision. The IRS has consistently ruled that only incidental benefits can accrue to private parties. For example, the fact that a risk pool provides jobs to employees of the state does not destroy the risk pool’s exemption under IRC § 115. The income accrual test appears to prevent any non-governmental entity from being a member of a risk-pool entity or from materially participating in the pool.

3. Scope of IRC § 115 Exemption for Risk Pools.

Over the years, the IRS has been willing to expand the exclusion in IRC § 115 somewhat beyond the classic model of a risk pool consisting solely of local political subdivisions of a single state.

- Pools that include members from multiple states clearly can take advantage of the exclusion.
- In addition, the IRC § 115 exclusion can even apply to pools that include other nonprofit corporations that are eligible for the IRC § 115 exclusion. The rulings do not explain the nature of these nonprofit members, but they could include municipal hospital corporations, state-run workers’ compensation companies, other risk pools or entities that perform a wide range of other activities.

4. Lack Of Specific Guidance on Inclusion of Nonprofit Corporations.

We have found no rulings or other authorities in which a nonprofit corporation (other than an IRC § 115 organization) was a member of a government risk pool. I note that one possible explanation for this lack of guidance may be procedural. PLRs are relatively expensive to obtain, due to legal fees for preparation of the written request and an IRS user fee that presently is \$11,500 for most requesting taxpayers and most issues. The IRS typically gives its reaction to the question early in the process so that, if the reaction is negative, the requesting taxpayer can withdraw its request without incurring the user fee or further legal fees. It is therefore possible that the lack of negative rulings reflects the IRS’s disapproval of the involvement of such nonprofit corporations in government risk pools.

5. Recent Rejection of Tribal Corporation As Member of Risk Pool.

We have found one PLR that suggests that the IRS interprets the “accruing to” requirement narrowly, denying the exclusion in IRC § 115 to any risk pool that includes members other than a state, a political subdivision of a state, or another entity that is eligible for the IRC § 115 exclusion because of its close connection with state or local government. That PLR, decided in 2006, involves the addition of a tribal corporation to an existing risk pool. *See* PLR 200637031.

- The risk pool previously had obtained a determination from the IRS that its income was exempt pursuant to IRC § 115, in part because its membership was limited to political subdivisions, including schools, counties and cities.
- The risk pool sought a second ruling that it would continue to be qualified if it added a tribal corporation as a member.
- The tribal corporation was an interlocal risk pool that provided insurance for the three tribes that created it, but it also provided insurance to other Indian tribes, various tribal entities, individual tribal members and businesses operated by individual tribe members.

The IRS ruled that addition of the tribal corporation would cause the Corporation to fail to meet the requirements of IRC § 115, even though the IRS noted that IRC § 7871 provides that Indian tribal governments are treated as states for certain specific purposes.

- In its ruling, the IRS appeared to rely solely on the fact that courts have held that “a tribe is not a state.”
- The IRS acknowledged that a tribal corporation has a tax status similar to that of a tribe, and the IRS did not mention in its analysis that the tribal corporation in question sold insurance to individual tribe members and to businesses operated by tribe members.

Thus, the IRS seemed to take a narrow view that participation by any entity other than a state (or, presumably participation by a political subdivision or a corporation eligible to exclude its income pursuant to IRC § 115) would destroy the exclusion for the nonprofit corporate risk pool.

6. Conclusion.

The addition of nonprofit corporations, other than those whose income is itself exempt pursuant to IRC § 115, creates a substantial risk of destroying a governmental risk pool’s ability to rely on IRC § 115 for exemption from federal income tax. Although federal tax law provides federal income tax exemption to many nonprofit corporations, primarily because of the social benefit that they provide, it appears that the IRS would likely consider a nonprofit corporation to be a “private interest” as opposed to a governmental interest. A tribe or tribal corporation seems to be in a better position than most nonprofit corporations to argue that it is not a “private interest” and that its participation in a government risk pool should not destroy IRC § 115 exclusion. The IRS’s rejection of that argument in the 2006 PLR implies that the IRS is unlikely to consider a nonprofit corporation eligible to join an IRC § 115 risk pool unless the nonprofit corporation member is itself eligible for the IRC § 115 exclusion.