



## MEMORANDUM

November 21, 2008

TO: MARY ELLEN COMBO

FROM: ROBERT T. MANICKE

CLIENT: State of Washington, Office of Financial Management

MATTER: Risk Management Division

RE: Responses to Scenarios Regarding Federal Income Tax Treatment of Risk Pools

You have asked us to comment on whether federal income tax is imposed in the four scenarios below. All of the scenarios involve pooling arrangements to spread risk among participants, known as "joint self-insurance programs" in RCW 48.62.031 or informally as "risk pools." The main variables among the scenarios involve the types of participants in the pool (nonprofit corporations, municipal governments of Washington, municipal governments of other states) and the types of activities engaged in by the pool ("pure" pooling of risk, additional services).

The federal income tax treatment of a risk pool depends primarily on the form of entity or legal arrangement among the members. The Washington statutes governing risk pools allow wide latitude in the choice of entity for the risk pool. RCW 48.62.031 requires that a risk pool be formed pursuant to an interlocal agreement under RCW 39.34. The agreement may create a separate "legal or administrative entity," including a Washington nonprofit corporation or a Washington partnership. RCW 48.62.031. Based on that statute, it appears that, in theory, a risk pool could be virtually any kind of legal entity, a governmental entity, or no legal entity but a mere contractual arrangement pursuant to which the participants are joint tenants or cotenants with respect to pooled assets. Immediately below is an overview of general principles governing the federal income tax treatment of risk pools consisting of different kinds of legal arrangements, including various theories that might allow an exclusion or exemption from federal income tax, followed by comments on the specific scenarios.

### General Principles

#### 1. Federal Income Tax Generally Does Not Apply to States.

##### a. Intergovernmental Immunity Applies to States and Political

**Subdivisions of States.** Courts have decided, and the Internal Revenue Service has ruled, that the U.S. Constitution implicitly provides that the federal government will not tax the states in a way that unduly burdens the states in the performance of their functions. *See* PLR 8842071.



This constitutional limitation appears to apply only in limited circumstances, namely, when the income in question is “uniquely capable of being earned only by a state.” *New York v. United States*, 326 US 572, 582 (1946) (upholding federal excise tax on sale of bottled mineral water by state). The doctrine does not prevent the federal government from imposing a nondiscriminatory tax on activities that are engaged in by nongovernmental and state-run enterprises alike. See *Massachusetts v. United States*, 435 US 444 (1978) (upholding federal registration fee on civil aircraft, including aircraft owned by states).

The doctrine applies to political subdivisions of a state as well as the state itself. A political subdivision generally is a division of state or local government that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit, such as the power to tax, the power of eminent domain, or the police power. See PLR 200238001 (ruling that fire protection district was a political subdivision of the state); Treas Reg § 1.103-1(b) (definition of “political subdivision” for purposes of tax-exempt bond financing).

b. **Intergovernmental Immunity Also Applies to an Organization That Is an “Integral Part” or “Instrumentality” of a State or Political Subdivision.** When a state or a political subdivision of a state acts through a department, agency or other organization rather than in its own name, courts and the Internal Revenue Service (“IRS”) analyze whether the organization is an integral part of a state or political subdivision, or an instrumentality of a state or political subdivision.<sup>1</sup> The “integral part” and “instrumentality” tests require that the state or political subdivision exercise a high degree of control over the enterprise and make a strong financial commitment to the enterprise. An entity that satisfies the “integral part” or “instrumentality” test is disregarded, and the income is treated as accruing to the state or political subdivision itself. In the IRS’s view, the income of such an organization is generally immune from tax under the intergovernmental immunity doctrine and is taxable only if specifically allowed by statute.

An example of an organization that satisfied the “integral part” test is a lawyer trust account fund. Lawyers in the state were required to deposit client trust moneys (generally, short-term and small amounts paid over by clients as advance payment for fees not yet incurred) into the fund. The fund commingled the amounts and used the earnings for public purposes. The state supreme court appointed the fund’s governing board and monitored its activities by attending meetings and receiving periodic accountings. Court employees carried out the day-to-day activities of the fund. The court had the authority to abolish the fund. See Rev Rul 87-2, 1987-1 CB 18 (concluding that fund’s income was not subject to tax).

The IRS has ruled that a multi-employer insurance program in which a state and political subdivisions participated was an “integral part” of the state. The program was established to provide a benefit for cancer-stricken firefighters who were active and retired government

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<sup>1</sup> The IRS has long taken the position that an “instrumentality” of state government or of a political subdivision is an organization that has been delegated the right to exercise sovereign authority such as taxing authority. See Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* § 6.10 (2003 & Supp 2006). An organization may be an “integral part” of government without such indicia of sovereignty.



employees. The program was established by the legislature and managed by a state agency. It was funded entirely by agencies of the state and participating political subdivisions. Thus, the requirements of state control and financial commitment were satisfied. The IRS described the activity as a “program” and did not state that any separate corporation had been formed to carry out the activities. *See* PLR 200210024 (concluding that program’s income was exempt from federal income tax).

## **2. Exclusion from Income Pursuant to Internal Revenue Code (“IRC”) Section 115 May Apply to an Organization That Does Not Satisfy the “Integral Part” or “Instrumentality” Tests.**

IRC § 115 states that gross income (which is the starting point in determining taxable income) does not include income “derived from \*\*\* the exercise of any essential governmental function and accruing to a State or any political subdivision thereof \*\*\*.” The IRS takes the position that IRC § 115 applies to an organization that is not an “integral part” of state or local government, but that nevertheless fulfills a governmental purpose and dedicates all of its income to state or local government. *See* PLR 8842071. In general, when the organization is separately incorporated, the IRS will likely conclude that it does not satisfy the “integral part” test and the taxability of its income should be analyzed pursuant to IRC § 115. An organization made up of a state and multiple political subdivisions is eligible for the exclusion in IRC § 115. *See* Rev Rul 77-261, 1977-2 CB 45 (applying IRC § 115 exclusion to incorporated investment fund).

a. **Key Authority: Revenue Ruling Regarding Taxability of an Insurance Risk Pool Under IRC § 115.** A 1990 revenue ruling establishes some principles of the application of IRC § 115 to risk pools. *See* Rev Rul 90-74. In contrast to a “private” letter ruling, a revenue ruling may be relied on by taxpayers as authority for planning purposes. The ruling involved a nonprofit corporation. State law allowed county governments to form the corporation and become members in order to pool the casualty risks of the participating counties. The corporation was controlled by a board of directors elected by the member counties. The corporation was funded in part by appropriations from the members that covered initial deposits and an annual fee based on the county’s size and actuarially determined risk level. The corporation also received investment income.

The IRS concluded that the corporation fulfilled an “essential governmental function” within the meaning of IRC § 115 because the workers’ compensation, casualty and liability risks covered by insurance or self-insurance through the pooling mechanism arose from governmental operations. The income “accrued to” the counties because the corporation used the income to reimburse losses of the counties or to reduce their annual participation fees.

In Rev Rul 90-74, the IRS noted repeatedly that “private interests” did not “participate in or benefit from” the corporation except for incidental benefits to employees of the participating state or political subdivisions. That fact seemed to be a factor in whether the corporation fulfilled an essential governmental function.

b. **IRC § 115 Organization Consisting of Other IRC § 115 Organizations.** In a 1999 private letter ruling (“PLR”), the IRS ruled favorably with respect to an incorporated captive insurance company whose members consisted of insurance risk pools.



See PLR 199924046. Each of the members was a political subdivision of a state, an integral part of a political subdivision, or an entity whose income was excluded from gross income pursuant to IRC § 115. The member risk pools were public housing authorities, and the function of the captive insurer was to provide reinsurance protection. The IRS ruled that the captive insurance company itself was eligible to exclude its income from gross income pursuant to IRC § 115, noting that “private interests” do not participate in or benefit from income of the captive. Thus, this PLR illustrates the IRS’s view that a risk pool need not consist solely of political subdivisions or integral parts or instrumentalities of state or local government in order to be eligible for the exclusion from income pursuant to IRC § 115; the exclusion may be available even if the member of the risk pool include nongovernmental entities that are eligible for the exclusion pursuant to IRC § 115.

**c. Multistate IRC § 115 Organization.** PLR 8944032 involved a trust formed by risk managers of four states. The trust formed an insurance company to provide insurance coverage to states and their political subdivisions pursuant to the federal Risk Retention Act, 15 U.S.C. §§ 3901-3906, which expressly authorizes two or more states and their political subdivisions to create risk retention groups. The IRS ruled that the trust and the insurance company were entitled to exclude their income pursuant to IRC § 115. *See also* PLR 199924046 (appears to contemplate that the members of the captive may be political subdivisions or integral parts of various states, or IRC § 115 entities formed by housing authorities that are not necessarily in the same state); PLR 200418018 (IRC § 115 exclusion available for nonprofit captive insurer owned by municipalities, counties, schools, public entity self-insured groups, risk pools and captive insurers of public entities, all of which were political subdivisions or IRC § 115 entities; no apparent restriction of membership to entities of the same state).

**d. Tribal Corporation’s Participation in a Nonprofit Corporation Similar to the Corporation Described in Rev Rul 90-74 Would Make the Nonprofit Corporation Ineligible for the Exclusion from Income Pursuant to IRC § 115.** In PLR 200637031, a nonprofit corporation (the “Corporation”) previously had obtained a determination from the IRS that the Corporation’s income was exempt pursuant to IRC § 115, in part because its membership was limited to schools, counties, cities and other political subdivisions. The Corporation sought a second ruling regarding whether it would continue to be qualified if it added the 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. In ruling that addition of the tribal corporation would cause the Corporation to fail to meet the requirements of IRC § 115, 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.



3. **If No Governmental Exemption Applies, the Risk Pool May Be Exempt As a Public Charity or Taxable As a Corporation.** An entity, including an informal association, but excluding a partnership may qualify for exemption from federal income tax as a public charity regardless of whether its members include governmental organizations, based on the same tests that apply to nongovernmental nonprofit organizations. We have not examined whether a charitable exemption would be available for an entity serving as a risk pool for governmental and nongovernmental tax-exempt entities. Assuming that a charitable exemption were available, the risk pool would need to apply to the IRS for recognition of its exempt status. *See* Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* § 23.1 (2003 & Supp 2006). If the risk pool were organized as a legal entity such as a nonprofit or business corporation, or if it were an association other than a partnership as discussed below, and if it were not exempt from federal income tax, then it would be taxed as a corporation. Its income would be subject to federal income tax at rates generally ranging up to 35% of net income. Furthermore, the members of the risk pool could be subject to tax on distributions or other income from the risk pool, unless an exemption applied at the member level.

4. **If the Risk Pool Is a Partnership the Risk Pool Itself Will Not Be Subject to Income Tax.** For federal income tax purposes, an entity that is formed as a partnership under state law is not subject to tax. IRC § 701. Rather, a partnership is a “passthrough entity,” and the partners are subject to tax on the income of the partnership unless an exemption applies at the partner level. *Id.* An entity such as a limited liability company (“LLC”) or a limited liability partnership may be classified as a partnership for federal income tax purposes as well, assuming that the entity has multiple members and does not elect to be classified as a corporation. *See* Treas Reg § 301.7701-2(c).<sup>2</sup> If the risk pool were treated as a partnership, then each member’s income tax treatment would depend on the member’s status as a governmental or nonprofit entity. A governmental member may not be subject to tax on income from the partnership, assuming that the intergovernmental immunity doctrine applies to the governmental member as described above.

5. **Treatment of Risk Pool As a Joint Tenancy or Cost-Sharing Arrangement.** If the risk pool were not formed as a separate legal entity, an argument potentially could be made that it is a joint tenancy or a mere cost-sharing arrangement and not subject to federal income tax. This status would depend primarily on whether the risk pool was engaged in profit-seeking activities, which is a highly factual question. If the risk pool fit into this status, the several members of the risk pool would be treated as direct actors with respect to the activities of the pool. As in the partnership scenario, each member’s income tax treatment would depend on the member’s status as a governmental or nonprofit entity.

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<sup>2</sup> There is some question whether a risk pool would be respected as a partnership for income tax purposes, if its only purpose were to share risk rather than to enter into a trade or business; however, if a risk pool were formed as a partnership pursuant to state law.



## Scenarios and Responses for Nonprofit Risk Pools

1. A joint risk pool insuring property and liability risks is formed under chapter 48.62 RCW. The membership consists of members registered as nonprofit corporations with the Secretary of State as required by statute. The federal tax designation of the members is unknown. Would the risk pool be subject to federal income tax liability?

**Response:** The risk pool should be eligible for the exclusion from income pursuant to IRC § 115 only if the income of the nonprofit corporate members of the risk pool is eligible for the exclusion pursuant to IRC § 115. If any nonprofit corporate member is not eligible for the IRC § 115 exclusion, then the IRS would likely conclude that income of the risk pool itself is not eligible for the exclusion pursuant to IRC § 115. This conclusion is based in part on the IRS's unwillingness to allow the exclusion if the membership of the risk pool includes any entity other than a state, a political subdivision, an integral part or instrumentality of a state or political subdivision, or another entity eligible for the exclusion pursuant to IRC § 115. *See, e.g.,* PLR 200637031 (discussed above; tribal corporation). If the IRC § 115 exclusion does not apply to the risk pool, then the income tax treatment of the risk pool and its members will depend on the risk pool's form of organization and on the tax situation of each member as discussed above.

2. A joint risk pool insuring property and liability risks is formed under chapter 48.62 RCW. The membership consists of nonprofit corporations registered with the Secretary of State as required by statute. The pool also shares risk with municipal government entities located in Washington. Would the risk pool be subject to federal income tax liability? If so, are all or a portion of the reserves owned by the program subject to federal income taxes?

**Response:** Regarding the tax treatment of the risk pool, the response is the same as under Question 1, namely, the issue is whether the nonprofit corporate members are eligible for the IRC § 115 exclusion. If so, the income of the risk pool should not be subject to federal income tax. This conclusion is based on the IRS's ruling that an entity consisting of political subdivisions and nonprofit corporations eligible for the IRC § 115 exclusion is itself eligible for the IRC § 115 exclusion. *See* PLR 199924046. Regarding whether the reserves owned by the program are subject to federal income tax, the tax is imposed only on net income, not on assets. Accordingly, if the income of the risk pool is generally exempt from tax pursuant to the intergovernmental immunity doctrine or IRC § 115, then the income from the reserves should be exempt as well. On the other hand, if the risk pool is generally taxable as a corporation, then tax would be imposed on the net income of the risk pool as a whole, meaning gross income from earnings on all of its aggregate reserves and from any other sources, less deductions for investment losses, operating expenses, depreciation and other items.

3. A joint risk pool insuring property and liability risks is formed under chapter 48.62 RCW. The membership consists of entities from multiple states. Among the members are nonprofit corporations registered with the Secretary of State in Washington, in addition to



municipal governments and nonprofit corporations from several states. Under what circumstances, if any, would the risk pool be subject to federal income tax liability?

**Response:** As discussed above, the fact that a risk pool includes members that are political subdivisions, integral parts or instrumentalities of various states, or IRC § 115 members based in various states, should not disqualify the risk pool from exemption pursuant to IRC § 115. *See* PLR 8944032 and other rulings discussed above. As in Scenarios 1 and 2, however, the risk pool may be subject to federal income tax if any of the nonprofit corporations is ineligible for the exclusion pursuant to IRC § 115.

4. A joint risk pool insuring property and liability risks is formed under chapter 48.62 RCW. The membership consists of entities from multiple states. Among the members are nonprofit corporations registered with the Secretary of State in Washington, in addition to municipal governments and nonprofit corporations from several states. The risk pool also sells other services, such as database management and risk management training, to “for profit” corporations and earns income through providing these services. Under what circumstances, if any, would the risk pool be subject to federal income tax liability?

**Response:** This Scenario builds on the first three by introducing new activities conducted by the risk pool. Assuming that the income of the risk pool otherwise would be nontaxable pursuant to the intergovernmental immunity doctrine or IRC § 115, the issue is whether the income from the sale of the additional services is “uniquely capable of being earned only by a state” for purposes of the intergovernmental immunity doctrine, and “derived from \*\*\* the exercise of any essential governmental function” for purposes of IRC § 115. Authority on these questions is limited and indicates that the result is highly dependent on the specific facts and circumstances. In general, the more closely the services resemble services that are provided by commercial entities, and the more the services are marketed to nongovernmental purchasers, the greater the likelihood that income derived from those services is subject to income tax. This conclusion follows from the general principle that the federal government is allowed to tax activities performed by a state that are not “uniquely capable” of being earned only by a state, as long as the tax does not discriminate against a state.<sup>3</sup> In the above scenario there appears

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<sup>3</sup> As stated by one commentator: “While no precisely defined test for direct taxation of the states has been enunciated, by negative definition one has begun to take shape. \* \* \* A direct tax cannot discriminate against a given state [or] group of states. It cannot tap a source of revenue which is capable of being earned only by the state. Ultimately the test is factual: the court will look at the nature and extent of what is actually being taxed. When the tax is more like a user fee, the test will be tripartite: first the tax must be uniform and cannot discriminate against state functions; second, the tax must be based on a fair approximation of use of the system; third, the tax cannot be excessive in relation to the cost of benefits supplied.” M. David Gelfand, *State & Local Government Debt Financing* § 1:13 (2008) (footnotes omitted).

to be some risk that income tax would apply to the income generated by the services described.<sup>4</sup>

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<sup>4</sup> There also may be some risk that the IRS might view the sale of these services to non-members as benefiting “private interests” in a way that would make the risk pool as a whole ineligible for exemption. *See* PLR 199924046; 200637031. A complete analysis of this question would require further understanding of the relevant facts.