

Federal Income Tax Classification of Governmental Entities and Affiliates

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Most governmental entities and political subdivisions are not subject to federal income tax based on the principles of inter-governmental immunity.¹ If an entity is separate from (not an “integral part”) of the governmental unit, its income is taxed unless an exemption applies or it qualifies as a tax-exempt entity.

Section 115 Organizations

A key exemption relied upon by affiliates of governmental units is set forth in Section 115 of the Internal Revenue Code of 1986, as amended (“IRC”).² It requires the income be derived from the exercise of an “essential government function” or that the income accrue to the benefit of the governmental unit.³ Some governmental instrumentalities and affiliates rely solely upon this exclusion for income tax purposes, while other organizations rely on an exemption under IRC Section 501(c)(3) discussed below. Some organizations rely on rely both exemptions.

In applying Section 115, the IRS inquires as to whether the organization performs services that otherwise would be performed by a governmental unit in furtherance of its statutory purposes, whether upon liquidation all residual assets of the affiliate will be distributed to the governmental unit to be used for public purposes, and whether the governmental unit controls the affiliate through its directors.⁴

The IRS has interpreted Section 115 in a series of revenue and private letter rulings in which the Service has found the following functions to be tax-exempt under Section 115:⁵

- income from property held in trust by a city that was to be used by the city for certain charitable purposes;⁶

¹ 869 BNA Tax Management Portfolios, Tax Exempt Organizations, A -63 at n.652 (hereinafter “Portfolio”).

² Section 115 provides as follows: Gross income does not include –

(1) 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; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

³ See Portfolio at A-63 & N.655.

⁴ PLR 9841009 (released October 9, 1998). A comprehensive interpretation of section 115(1) of the Code is set forth in G.C.M. 14407, XIV-1 C.B. 103 (1935), as superseded by Rev. Rul. 71-131, 1971-1 C.B. 28, in discussing the corresponding section of a prior statute (section 116(d) of the Revenue Act of 1934). It is indicated therein that the predecessor section of what is now section 115(1) of the Code was intended to refer, not to the income of a State or municipality resulting from its own direct participation in industry, but rather to that part of the income of a corporation engaged in the operation of a public utility or the performance of some governmental function that accrued to a State or municipality.

⁵ Although private letter rulings cannot be relied upon as legal precedent, they give a good indication of how the IRS would rule on a similar fact pattern.

⁶ Rev. Rul. 71-589, 1971-2 C.B. 94, provides that the income from property held in trust by a city that was to be used by the city for certain charitable purposes is not subject to federal income tax. Although Rev. Rul. 71-589 does not explicitly so state, the holding in the revenue ruling means that a determination was made that the income in question was derived from the exercise of an essential governmental function and accrued to a political subdivision within the meaning of § 115(1) of the Code. Rev. Rul. 71-589 specifically mentions several types of functions that the trust might perform, such as support of a hospital, schools, maintenance of a park, or other purposes ordinarily recognized as a municipal function.

- support of a hospital, schools, maintenance of a park, or other purposes ordinarily recognized as a municipal function;⁷
- income of a fund, established under a written declaration of trust to the pool the temporary investments of a state and its political subdivisions;⁸
- an organization that is 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;⁹
- issuance of bonds for the purpose of construction a new city building;¹⁰
- pooling the purchasing power of governmental entities to take advantage of volume discounts;¹¹
- reducing governmental entity costs by consolidating bidding and contracting procedures;¹²
- serving as a products, services, and financing resource for government agencies;¹³
- assisting governmental entities with financing for businesses that contribute to the community;¹⁴
- providing workers' compensation, general and auto liability insurance for its parent nonprofit corporation that provided transit services for a city and county;¹⁵ and

⁷ *Id.* See also PLR 9841009 and PLR 9842005.

⁸ Rev. Rul. 77-261, 1977-2 C.B. 45, concludes that the income of a fund, established under a written declaration of trust to the pool the temporary investments of the state and its political subdivisions, is excludable from gross income under section 115(1) of the code. The fund was authorized by state statute, managed by the state treasurer, and benefited only the state and its political subdivisions. The ruling states that the investment of funds is a necessary incident of the power of governmental entities to raise revenue and meet expenses.

⁹ Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization that is 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. Rev. Rul. 90-74 states that the income of the organization is excluded from gross income under § 115(1) of the Code if private interests do not participate in the organization or benefit more than incidentally from the organization.

¹⁰ In Private Letter Ruling 200019023, a nonprofit corporation was incorporated by a city in order to issue bonds for the purpose of construction a new city hall. The corporation leased all of its property to the city for the city's use. The rent the corporation received satisfied its debt service on the bonds. The corporation was managed by officials of the city, the organizational documents provided that all earnings inure to the benefit of the city, and upon dissolution all remaining assets would be distributed to the city or other tax-exempt organization. The Service concluded that the corporation was an "affiliate of a governmental unit" within the meaning of section 4 of Rev. Proc. 95-48.

¹¹ In Private Letter Ruling 200008024, a nonprofit corporation was incorporated by a state authority for several purposes: (i) to enable governmental entities to pool their purchasing power to take advantage of volume discounts; (ii) to reduce costs by consolidating bidding and contracting procedures; (iii) to serve as a products, services, and financing resource for government agencies; and (iv) to assist governmental entities with financing for businesses that contribute to the community. The corporation was precluded from distributing its property or profits to any private person. The corporation was managed by governmental officials. The Service concluded that the corporation was performed the same tasks that states and political subdivisions perform and that it was therefore tax exempt under Section 115.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ In Private Letter Ruling 200129015, a captive insurance company was formed for the purpose of providing workers' compensation, general and auto liability insurance for its parent nonprofit corporation. The parent was organized to provide transit management services for a city and county. Its income was ruled exempt under Section 115. The insurance company was precluded from distributing its property or profits to any

- providing electric and natural gas utilities on behalf of a city.¹⁶

Organizations whose income is tax-exempt under Section 115 are not required to file an informational tax return on Form 990.¹⁷ Treas. Reg. §1.6033-2(g)(v) provides that “a State institution, the income of which is excluded from gross income under section 115(a)” is not required to file an annual return.¹⁸ However, the exemption from having to file a return does not apply if the entity has unrelated business taxable income under IRC Section 511.¹⁹

In most instances, if a Form SS-4 is properly filled out reflecting that the organization is a governmental entity, the IRS will not challenge the entity’s classification of itself as a governmental affiliate whose income is exempt. However, private letter rulings are available.²⁰

IRC Section 170 provides that donations made for exclusively public purposes, to or for the use of a state or political subdivision, are deductible against the taxable income of individuals, corporations, and other taxpayers, subject to various limitations.²¹ However, because Section 115 organizations do not typically have a determination letter or an approved application for tax-exempt status, potential donors are sometimes reluctant to make a charitable contribution. In such circumstances, consideration should be given to qualifying the organization under Section 501(c)(3).

Section 501(c)(3) Organizations

Wholly owned governmental entities, such as certain nonprofit corporations, can qualify as a tax-exempt organization under IRC Section 501, if they are organized separately from the governmental entity.²² This is particularly so if the affiliated entity lacks basic governmental powers.²³

Most affiliated governmental entities qualify under Section 501(c)(3) as a “charitable organization.”²⁴ Included within the definition of a “charitable organization” are organizations involved in the “erection of public buildings, monuments, or works” and “lessening the burdens of government.”²⁵

private person. The corporation was managed by representatives of the parent corporation. The Service concluded that the insurance company’s income was tax exempt under Section 115.

¹⁶ In Private Letter Ruling 199930028, a nonprofit corporation qualified under Section 501(c)(3) was a utility company that was wholly owned by a city. The utility provided electric and natural gas utilities on behalf of the city. All net income of the utility accrued to the city. The Service concluded that the net income of the utility was exempt under Section 115 and that the utility was a “state institution” under Reg. §1.6033-2(g)(1)(v) corporation was not required to file an annual return.

¹⁷ Form 990 is an information return that Section 501(c)(3) organizations are generally required to file with the Internal Revenue Service on an annual basis. Such returns must also be made available to the public upon request.

¹⁸ See PLR 200019023 and PLR 199930028.

¹⁹ See discussion accompanying footnotes 46-48 below. If an entity has unrelated business taxable income it must file a return on Form 990-T.

²⁰ See Rev. Proc. 2003-1; Rev. Proc. 2003-4; Rev. Proc. 2003-8 (fee of \$2,470, unless gross receipts of organization are less than \$200,000 in which case the fee is \$600).

²¹ For estate tax purposes, IRC Section 2055(a) provides that bequests, legacies, devises, or transfers made by an estate for exclusively public purposes, to or for the use of any state or political subdivision, are deductible from the value of the gross estate subject to various limitations. For gift tax purposes, IRC Section 2522(a) provides that transfers made for exclusively public purposes, to or for the use of any state or political subdivision, are deductible in computing taxable gifts subject to various limitations.

²² Rev. Ruling 60-384, 1960-2 C.B. 172; Rev. Ruling 55-319, 1955-1 C.B. 119. For entity classification purposes, an entity exempt under IRC §501(a) is treated as having made an election to be classified as an “association.” Treas. Reg. §301.7701-3(c)(v). An entity with at least two members classified as an association can elect to be classified as either a corporation under Sec. 301.7701-2(b)(2) or a partnership. Treas. Reg. §301.7701-3(a).

²³ See Portfolio at A-64.

²⁴ IRC Section 501(c)(3) provides:

In order to qualify as an exempt organization under Section 501(c)(3), the articles of incorporation, organization, or other charter documents must meet an organizational test. The organizational test requires that the purposes of the organization be limited to one or more of the Section 501(c)(3) purposes.²⁶ The charter documents must not expressly empower it to engage in activities that do not further one or more of those purposes, other than as an insubstantial part of its activities.

The charter of the organization must also meet dedication and distribution of asset tests.²⁷ This requires the assets of the organization be permanently dedicated to an exempt purpose. This means that if an organization dissolves, its assets must be distributed for an exempt purpose in Section 501(c)(3) or to the federal government or to a state or local government for a public purpose. If the assets could be distributed to members or private individual or for any other purpose, the organization test is not met.²⁸

Organizations claiming exempt status as a charitable organization under Section 501(c)(3) must notify the IRS within 15 months of the date of organization that they are applying for exempt status on Form 1023.²⁹ Churches and organizations with less than \$5,000 in gross receipts are exempt.³⁰

Governmental affiliates also should avoid being classified as a "private foundation" for tax purposes in that private foundations are subject to numerous operating restrictions and excise taxes. To avoid being classified as a "private foundation" an organization must meet on the tests set forth in IRC Section 509(a).

Subsection 509(a)(1) deals with various entities as defined in IRC Section 170(b)(1)(A)(i)-(vi). Subsection (v) deals with governmental affiliates that themselves are a political subdivision and have sovereign powers.³¹ Subsection (vi) provides a classification for organizations that are publicly supported. A publicly supported organization is one that normally receives a substantial part of its support from a governmental unit or from the general public. An organization will qualify if it passes the one-third support test, and if it fails that test, it may qualify under a facts and circumstances test. The one-third support test is met if the organization normally receives at least one-third of its total support from governmental units. This is therefore the most likely application for governmental affiliates who are funded directly by contributions from the governmental entity.

Organizations that are new must apply for an advance ruling.³² If a newly created organization has not obtained an advance ruling, it cannot rely upon the possibility that it will meet the public support requirements.³³

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

²⁵ Reg. §1.501(c)(3)-1(d)(2).

²⁶ IRS Pub. 557 at 17.

²⁷ Id.

²⁸ Id. (Examples are set forth in IRS Pub. 557 at 18-19.)

²⁹ Reg. §1-508-1.

³⁰ Id.

³¹ Portfolio at A-73-74 & N.758.

³² IRS Pub. 557 at 30, 32.

³³ IRS Pub. 557 at 32.

Subsection 509(a)(2) applies mostly to governmental affiliates who derive most of their revenues from exempt function income.³⁴ Generally, these also fit under 509(a)(1), but there are two basic differences:

1. For 509(a)(2) organization the term support includes items of support and income from tax-exempt activities. Such income is not used in determining qualification under 509(a)(1).
2. Section 509(a)(2) places a limit on the gross investment income and unrelated business taxable income an organization may have, while Section 509(a)(1) does not.

The 509(a)(2) tests include a one-third support test and a not more than one third support test. The one-third support test will be met if an organization normally receives more than one-third of its support in each tax year from any combination of gifts and gross receipts

As with Section 509(a)(1) organizations, new organizations must apply for an advance ruling.³⁵ If a newly created organization has not obtained an advance ruling, it cannot rely upon the possibility that it will meet the public support requirements.³⁶

For organizations that qualify under both subsections, Reg. 1.509(c)-6 provides that IRC 509(a)(1) will apply. However, BNA indicates that if almost all gross receipts from related activities as defined in §509(d) and there is only insignificant public support in §170(b)(1)(A)(vi), then §509(a)(2) applies. BNA indicates the scope of the Reg. §1.170A-9(c)(7)(ii) is unclear.

For newly formed organizations, in addition to filing a Form 1023 to apply for exempt Section 501(c)(3) status, they should also seek an advance ruling on the public charity status. Form 1023 is also used for this purpose.³⁷ A consent on Form 872-C should accompany the filing.³⁸

Tax Returns

Governmental affiliates are also often exempt from filing an information tax return on Form 990 in one or more of the following circumstances:

- a state institution whose income is excluded from gross income under Section 115 is exempt;³⁹
- a governmental unit or affiliate of a governmental unit described in Rev. Proc. 95-48 is also exempt;⁴⁰ and
- an organization whose annual gross receipts are normally \$25,000 or less.⁴¹

³⁴ 876 BNA Tax Management Portfolio, Private Foundation, Public Charities, A-35.

³⁵ IRS Pub. 557 at 30, 32.

³⁶ IRS Pub. 557 at 32.

³⁷ Reg. §1-508-1(b).

³⁸ 876 BNA Tax Management Portfolio at A-35.

³⁹ Treas. Reg. §1.6033-2(g)(v).

⁴⁰ 1995- C.B. 418.

These exceptions do not apply with regard to unrelated business taxable income.⁴²

With regard to Rev. Proc. 95-48, it relieves most governmental instrumentalities of the requirement to file a Form 990. This revenue procedure specifies two classes of organizations that are not required to file the annual information return. These two classes are (1) governmental units,⁴³ and (2) affiliates of governmental units that are exempt from federal income tax under IRC Section 501(a).

If the “affiliate of a governmental unit” is described in Section 501(c) of the Code and has a ruling or determination from the Service that (i) its income is excluded under IRC Section 115; (ii) it is entitled to receive deductible charitable contributions under Section 170(c)(1), or (iii) it is a wholly owned instrumentality of a state or a political subdivision for employment tax purposes, then the entity is excepted from the requirement of filing an annual information return on Form 990.⁴⁴ If the “affiliate” does not have such ruling or determination, then the following two requirements must be satisfied:⁴⁵

First, the organization must be controlled by a governmental unit. This means that a governmental unit (or a public official acting in his official capacity) must appoint the majority of the members of the organization’s governing body. A governing body elected by the public also satisfies this requirement. For purposes of this control test, a governmental unit is a state, a possession of the United States, or a political subdivision.

Second, the organization must satisfy two of the five affiliation factors listed in the revenue procedure indicating actual oversight of its financial affairs and activities by the governmental unit.

At the time it files its application for recognition of exemption under IRC Section 501(a), an organization may request a determination that it meets the requirements to be excepted from filing Form 990.

Unrelated Business Taxable Income

Tax-exempt status does not, however, apply to unrelated business activities. On these activities, tax-exempt organizations are required to report and pay federal income tax.⁴⁶ Unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis for the organization’s exemption.⁴⁷ Unrelated business activities are revenue producing activities that:

- 1) are not directly related to accomplishing the organization’s tax-exempt purpose;

⁴¹ Treas. Reg. §1.6033-2(g)(iii) and Instructions for Form 990. The organization’s gross receipts are the total amount it received from all sources during its annual accounting period, without subtracting any costs or expenses. *Id.*

⁴² See text accompanying notes 46-48 below.

⁴³ Governmental units include (i) a state or local governmental unit as defined in Treas. Reg. §1.103-1(b); (ii) the entity is entitled to receive deductible charitable contributions as an organization described in Section 170(c)(1); or (iii) it is an Indian tribal government, or a political subdivision thereof, under Section 7701(a)(4) and 7871 of the Code.

⁴⁴ Rev. Proc. 94-48, Section 4.02(a).

⁴⁵ Rev. Proc. 94-48, Section 4.02(b).

⁴⁶ IRC Section 511.

⁴⁷ IRC Section 512, 513.

2) are conducted for the primary purpose of earning a profit; and

3) compete with commercial businesses that provide similar services to the public.

Such activities may be subject to unrelated business income tax, which is imposed at the same tax rates applicable to for-profit corporations. A tax-exempt organization must make estimated tax payments if it expects its tax (unrelated business income tax after certain adjustments) to be \$500 or more. An exempt organization that has \$1,000 or more of gross income from an unrelated business must file a return on Form 990-T.⁴⁸

⁴⁸ For additional information on unrelated business income, see IRS Publication 598.