INTERNAL REVENUE SERVICE
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LEGEND:

Authority =

State A =

Year 1 =

County =

Date 1 =

Program =

Date 2 =

Department =

v =

w =

x =

y =

Year 2 =

z =

Date 3 =

Date 4 =

Dear

This is in reply to a letter dated August 14, 1998, and subsequent correspondence, requesting certain rulings on behalf of Authority. The requested rulings concern whether Authority may be treated as an integral part of State A for federal income tax purposes, or, alternatively, whether Authority is subject to § 115 of the Internal Revenue Code. You have also requested a ruling concerning the deductibility of contributions to Authority under § 170(c)(1).

FACTS:

The State A Legislature in Year 1 passed legislation that allowed County to establish a public agency to meet medical needs of the indigent. Under this legislation, the Board of Supervisors for County (Board) established a Commission to deliver publicly assisted medical care in County. On Date 1, the Board established, by resolution and on behalf of the Commission, Authority, a public agency, which the Commission owns and operates as a local initiative public assistance health plan, to provide managed health care to Program eligible beneficiaries in County. Program is State A's implementation of the federal Medicaid program. Authority was established to provide managed health care for indigent persons in County by contracting with hospitals, doctors, and other health care service providers on behalf of Program eligible beneficiaries.

The State A Legislature intended for the implementation of the public agency to involve consultation and cooperative activities from various agencies of State A, County, and the Commission, and that those activities would be in furtherance of State A's goals and efforts. The activities of the Commission and Authority are recognized as State A action for purposes of all statutes and regulations relating to business competition. Authority is deemed a public agency that is a local unit of government for purposes of all grant programs and other funding and loan guarantee programs of State A.

On Date 2, the Board established, by ordinance and on behalf of the Commission, Authority, as an entity separate and distinct from the County. The County has no responsibility for the financial obligations and liabilities of Authority. Also, Authority is exempt from County hiring and operations requirements.

The governance of Authority is vested in Commission, which consists of thirteen members appointed by the Board. The members of the governing body are selected as follows. Four members are selected by the Board in its discretion. The other members are selected by the Board from groups specified in State A legislation as follows. One member must be a representative of private hospitals that have Program status. One member must be a representative of private hospitals that do not have Program status. One member must be a representative of free and community clinics. One member must be a representative of federally qualified health centers. One member must be a physician representative. One member must be a representative of a licensed prepaid health plan. One member must be an individual who is a health care consumer. One member must be a health care consumer advocate. One member must be a children's health care provider representative.

The members of the Board of Governors and employees of Authority are immune from liability as public employees. Members of the Board of Governors of Authority are required to file public statements disclosing their assets and are prohibited in participating in a decision in which the member has a financial conflict of interest.

The composition of the 13-member governing body of Authority is subject to alteration upon a two-thirds vote of the full membership of the governing body, if the action is also concurred in by an affirmative vote of at least four members of the Board.

The auditor-controller of County conducts a review of the fiscal condition of Authority at least annually and reports the findings to the Board and Authority. The auditor-controller also has the discretion to conduct, at any time, other operational or financial audits of Authority and to review Authority's books and records.

Authority may be terminated by the Board if it no longer functions for the purpose for which it was established, when Authority's existing obligations have been satisfied or when its assets have been exhausted. Upon termination of Authority by the Board, County must manage any remaining assets of Authority until superseded by a plan approved by Department, which is part of State A.

Meetings of the Board of Governors of Authority and its committees are subject to the open meeting laws for governmental agencies in State A. The documents and records of Authority are open to inspection as public records. Authority is required to file a statement as a local unit of government.

Under State A legislation, all of the powers and permitted activities of Authority are limited by a strategic plan written by Department. Department may amend the strategic plan, changing Authority's power.

Prior to the creation of Authority, County entered into a contract with Department to operate the local initiative public assistance health plan for County. After the creation of Authority, County, Department, and Authority entered into a novation, transferring County's contract with Department to Authority. Authority also has entered into a contract with Department to operate a family program, which provides managed health care to families with limited income in County.

The funding for Authority was authorized under a State A statute, which appropriated $v of State A funds to be used by Department. The $v allocated to Department by State A was matched by a $v federal grant, creating a $w pool of funds. From this pool of funds, Department distributed $x to County for the formation and operation of Authority.

Additionally, Authority receives payments under its contract with Department for Program. Under the Medicaid program, money is granted to States that adopt plans to provide medical assistance to indigent persons. Approximately one-half of the money Authority receives under its contract is from State A and the balance is from a federal grant to State A for Program. This contract provided Authority with $y for rendering services for Year 2.

Under a second contract with Department, Authority receives additional funds for providing health care to families with limited income. This contract will provide Authority with $z for rendering services for the period Date 3 through Date 4. Also, County may lend funds to Authority upon such terms as the Board may establish.

LAW, ANALYSIS AND CONCLUSIONS:

Integral Part

Generally, if income is earned by an enterprise that is an integral part of a state or political subdivision of a state, that income is not taxable in the absence of specific statutory authorization to tax that income. See Rev. Rul. 87-2. 1987-1 C.B. 18; § 511(a)(2)(B); Rev. Rul 71-131, 1971-1 C.B. 28; Rev. Rul. 71-132, 1971-1 C.B. 29. When a state or political subdivision conducts an enterprise through a separate entity, however, the income of the entity may be exempt or excluded from income under a specific provision such as § 501 and § 115.

In Maryland Savings-Share Insurance Corp. v. United States, 308 F. Supp. 761, rev'd on other grounds, 400 U.S. 4 (1970) (MSSIC), the State of Maryland formed a corporation to insure the customer accounts of state chartered savings and loan associations. Under MSSIC's charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Only three of eleven directors were selected by state officials. The district court rejected MSSIC's claim of intergovernmental tax immunity because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Thus, the imposition of an income tax on MSSIC would not burden the State of Maryland. Although the Supreme Court reversed the lower court on other grounds, it agreed with the lower court's analysis of the instrumentality and § 115 issues.

In State of Michigan and Michigan Education Trust v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992), the court held that the investment income of the Michigan Education Trust (MET) was not subject to current taxation under § 11(a). The court's opinion is internally inconsistent because it concludes that MET qualifies as a political subdivision of the State of Michigan (Id. at 825), that MET is "in a broad sense" a municipal corporation (Id. at 826), and that MET is in any event an integral part of the State of Michigan (Id. at 829). Moreover, the court's reliance on the factors listed in Rev. Rul. 57-128, 1957-1 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from a state. The factors in the revenue ruling do not determine whether an enterprise is considered to be a separate entity or an integral part of a state.

Nevertheless, in determining whether an enterprise is an integral part of a state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise.

Section 301.7701-1 et seq. of the Procedure and Administration Regulations, the so-called "check-the-box" regulations, support the position that an entity that is separate from a state or political subdivision may still be an integral part of that state or political subdivision. Section 301.7701-1(a)(3) provides, in part, that:

> An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.

Section 301.7701-2(a) provides:

> For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-2(b) provides, in part:

> For federal tax purposes, the term corporation means--
>
> (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
>
> (2) An association (as determined under § 301.7701-3);
>
> ***
>
> (6) A business entity wholly owned by a State or any political subdivision thereof.

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

In this case, Authority was created by enabling legislation of State A and an implementing resolution and ordinance of County. The powers of Authority are included in the legislation that established Authority. The Board appoints the members of the Board of Governors that controls Authority. The financial affairs of Authority are reviewed and may be audited by the auditor-controller of County. All of the activities of Authority are subject to the requirements for all governmental entities of State A with respect to its procedures and litigation. County has the authority to terminate Authority, and Department would determine the ultimate disposition of Authority's assets. Also, the permitted activities of Authority are subject to the control of Department which may expand or limit these activities through revisions of its strategic plan. Based on the information submitted, we conclude that State A will exercise substantial control over Authority.

The funding for Authority was authorized under State A statute, which appropriated $v of State A funds to be used by Department, which is part of State A. The allocation to Department by State A was matched by a $v federal grant, creating a $w pool of funds. From this pool of funds, Department distributed $x to County for the formation and operation of Authority. County has no direct responsibility for the financial obligations and liabilities of Authority.

Additionally, Authority receives payments under its contract with Department for Program. Approximately one-half of the money Authority receives under its contract is from revenues from State A and the balance is from a federal grant to State A for Program. This contract provided Authority with $y for rendering services for Year 2.

Under a second contract with Department, Authority receives additional State A funds for providing health care to families with limited income. This contract will provide Authority with $z for rendering services for the period Date 3 through Date 4. The allocation of the above-mentioned funds represents a substantial financial commitment by State A to Authority.

Accordingly, based on the facts and representations submitted, State A, through County, has demonstrated that it will exercise a substantial level of control over Authority. State A, through Department, will make a substantial financial commitment to Authority. Therefore, we conclude that Authority's income is not subject to federal income tax because Authority is an integral part of State A.

Section 115

Because we have concluded that Authority is an integral part of State A, § 115 is not applicable.

Section 170

Section 170(a)(1) provides, subject to certain limitations, a deduction for contributions or gifts to or for the use of organizations described in § 170(c), payment of which is made within the taxable year.

Section 170(c)(1) states that the term "charitable contribution" includes a contribution or gift to or for the use of a state, a possession of the United States, any political subdivision of a state or any possession of the United States, or the District of Columbia, but only if the contribution is made for exclusively public purposes. See, e.g., Rev. Rul. 79-323, 1979-2 C.B. 106 (holding that amounts contributed to an industrial commission established by a state legislature for exclusively public purposes are deductible under § 170(c)(1)).

Authority was created under State A statute to provide managed health care for indigent persons and certain limited income families in County. Authority is under the control and supervision of County and is funded by State A and from federal money paid to State A. Authority functions for "an exclusively public purpose" as required by § 170(c)(1) for contributions to a state to be deductible.

Because Authority is an integral part of State A, contributions or gifts to or for the use of Authority are contributions or gifts to or for the use of an entity described in § 170(c)(1). Accordingly, contributions or gifts to or for the use of Authority are to or for the use of State A and are for exclusively public purposes and are therefore generally deductible under § 170(c)(1) to the extent otherwise provided under § 170.

Section 170(b)(1) provides limitations on the amount that an individual can deduct for charitable contributions in a taxable year. Section 170(b)(1)(A)(v) provides that any charitable contribution to a "governmental unit" referred to in § 170(c)(1) is allowed to the extent that the aggregate of such contributions does not exceed 50 percent of the taxpayer's contribution base for the taxable year.

Because Authority is an integral part of State A, Authority is a "governmental unit" described in § 170(b)(1)(A)(v).

OTHER INFORMATION:

This ruling is directed only to the taxpayer who requested it. No opinion is expressed as to the federal tax consequences of this transaction under any provision not addressed herein.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to taxpayer’s authorized representative.

Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: signed by Alvin J. Kraft
Alvin J. Kraft
Chief, Branch 1

Enclosures:
Copy of this letter
Copy for § 6110 purposes