Office of Chief Counsel
Internal Revenue Service
memorandum

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to: EO/FSLG Employment Tax Coordination Task Force

from: Robin J. Ehrenberg
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subject: EO/FSLG Employment Tax Coordination Task Force: Taxation of dual character taxpayers

You have requested our views, for the team's consideration, on the following:

[redacted] DP

[redacted] DP

[redacted] DP

Regarding requests one and two, we enclose edited versions of these materials herein. Because the edits and comments are self explanatory, this memorandum focuses on request three.

Project Background

In three separate reports, TIGTA has addressed the issue of FSLG's proper identification of the taxpayers for which it has exam responsibility.[1] FSLG has

[1] *To Provide Quality Service, the Government Entities Organization First Needs to Identify Its Customers,* Rpt. Ref. No. 2002-10-102; *The Federal, State, and Local Governments Office Is Taking Action to Identify Its Customers, but Improvements Are Needed,* Rpt. Ref. No. 2004-10-104; *Resource and Computer Programming Limitations Have Hindered the Progress of the Federal, State, and Local Governments Office in Identifying Its Customers,* Rpt. Ref. No. 2006-10-124.

conducted various projects to address TIGTA's findings and recommendations, including sending approximately 26,000 letters[2] to taxpayers identified in a 2002 Bureau of Census (but not in any IRS) database as government entities, asking them if they considered themselves government entities.

If a taxpayer is both a government entity and an exempt organization, it presents a problem with various IRS computer systems, because the systems are programmed to accept a single-digit "employment code" to identify an entity. The assigned code is based on the entity's status; for example, "G" identifies a government entity and "W" identifies a non-profit organization exempt from FUTA (i.e., a § 501(c)(3) organization). See IRM 3.13.12.6.29. The IRS computer systems accept only one employment code identifier per taxpayer and it is this status identification that determines which division and unit has primary audit responsibility for a taxpayer.

FSLG has identified a number of taxpayers that may be both a government entity and an organization exempt from Federal income tax under § 501(a) ("dual character" entities). FSLG is concerned that this dual status can create different results under certain employment tax provisions of the Code, based on which status the entity chooses to use for employment tax purposes. To illustrate these conflicts, we requested that you provided us with three to five representative scenarios. Although we have yet to receive these from you, due to competing demands on your time, we are providing a general discussion of the law that applies to determining when an entity is a government entity and when such an entity may have a dual tax character. In brief, we conclude that the law does not require a dual character entity to choose one status for all tax purposes. Situations involving the taxation of a dual character entity must be analyzed on a case-by-case basis.

Law

Employment Taxes

Generally, employers must withhold and pay federal employment taxes on wages paid to their employees.[3] For Federal employment taxes to apply, three threshold conditions must exist—there must be an "employer," an "employee," and a payment of "wages."

Section 3402(a) of the Internal Revenue Code (Code) requires employers to deduct and withhold income tax on wages, and provides that the term "wages" generally means all remuneration for services performed by an employee for an employer. Under §§ 3111 and 3301, FICA and FUTA impose excise taxes on the employer in an amount equal to a percentage of the wages paid by that employer. Under § 3101, FICA taxes are also

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[2] Letter 4147 and Form 13815, *Government Entity Assessment.*

[3] Federal employment taxes generally consist of income tax withholding (§§ 3401-3405), Federal Insurance Contributions Act (FICA) taxes (§§ 3101-3128), and Federal Unemployment Tax Act (FUTA) taxes (§§ 3301-3311).

imposed on the employee. Sections 3121(a) and 3306(b) define the term "wages" for FICA and FUTA purposes, generally as all remuneration for employment. Sections 3121(b) and 3306(c) define "employment" as any service, of whatever nature, performed by an employee for the person employing him.

While these employment tax provisions of the Code apply generally to government entities and exempt organizations, certain provisions apply specifically to government entities and exempt organizations.

Relevant FICA Provisions. For purposes of FICA taxes, § 3121(b)(7) excludes from the definition of "employment" service performed in the employ of four employer categories: 1) a State; 2) any political subdivision of a State; 3) any wholly owned instrumentality of a State; and 4) any wholly owned instrumentality of a political subdivision of a State. Under § 3121(b)(7)(E), these employers are subject to Social Security taxes on wages paid to their employees if the services are covered under a "218 agreement" between the State and the Social Security Administration under section 218 of the Social Security Act. Assuming the employer is not covered by a 218 agreement, section 3121(b)(7)(F), however, provides that this exclusion from employment will apply only when employees of these four employer categories are members of their employers' retirement system.

Accordingly, wages paid to employees of these employers are subject to Social Security taxes (§§ 3101(a), 3111(a)) unless these employers are not covered by a 218 agreement and they cover the employees in their retirement systems. Wages paid to employees of these, and other, employers are also generally subject to Medicare taxes, without regard to retirement system coverage. § 3121(u).

Under § 3121(a)(16), an exemption from FICA tax is provided for remuneration paid by an organization exempt from income tax under § 501(a) (other than an organization described in § 401(a)) or under § 521 in any calendar year to an employee for service rendered in the employ of such organization, if the remuneration paid in such year by the organization to the employee for such service is less than $100.

Relevant FUTA Exclusions. For purposes of FUTA taxes, § 3306(c)(6) generally excludes from the definition of "employment" services performed in the employ of the United States Government, or in the employ of any instrumentality of the United States that is wholly or partially owned by the United States. Section 3306(c)(7) generally excludes from FUTA, among others, all services performed for employers exempt from FICA under § 3121(b)(7). Section 3306(c)(8) excludes from FUTA services performed in the employ of an organization described in § 501(c)(3) and exempt from income tax under § 501(a).

There are no similar income tax withholding provisions, government entities and exempt organizations are generally subject to the same rules as private employers.

Employment Tax and Government Entity Status

The fundamental reason an entity wants to be characterized as a government entity within the meaning of section 312(b)(7)(F) is to avoid the payment of FICA taxes. The principal administrative guidance used to determine whether an entity is an instrumentality of government for employment tax purposes is Rev. Rul. 57-128, 1957-1 C.B. 311. Although the Service and the Courts have used this ruling in other tax contexts, it is an application of the FICA and FUTA tax provisions to the facts in the ruling for employment tax purposes.

Rev. Rul. 57-128, provides the following factors to consider in determining whether an organization is an instrumentality of one or more states or political subdivisions: (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses.

Section 115 and Section 501(c)(3)

State and local governments periodically form corporations and other entities that conduct various governmental activities, but do not meet the requirements to be a political subdivision. Section 115(1) of the Code provides relief from taxation in the form of an exclusion from gross income for these entities.[4]

Section 115 provides that:

> Gross income does not include 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 income accruing to the government of any possession of the United States, or any political subdivision thereof.[5]

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[4] Note that tribal corporations cannot exclude their gross income from tax under § 115.

[5] The Tariff Act of 1913 (Tariff Act of October 3, 1913, ch. 16, II, 38 Stat. 166) imposed a tax on the income of individuals and corporations. It also included section IIG(a), the original predecessor of § 115(1). Congress decided to incorporate the accrual requirement at the request of states and municipalities, but also decided, on its own, to add the "essential government function" requirement. See *Hearings on H.R. 3321 before the Senate Committee on Finance, 63d Cong., 1st Session, vol. 3, pt. 13* (1913) at 2053 – 2057; and H.R. Conf. Rep. No. 86, 63d Cong., 1st Session, at 15-16 (1913), reprinted in 50 Cong. Rec. No. 5222, 5226 (1913). (H.R. 3321 was enacted as the Tariff Act of 1913). The predecessors of § 115(1) are §§ IIG(a) (1913), 11(b) (1916), 213(b)(7) (1918), 116(d) (1928), and 115(a) (1954).

There are no regulations under § 115(1) providing any further interpretation of the statutory language.

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in § 501(c). Section 501(c)(3) of the Code describes organizations that are organized and operated exclusively for one or more exempt purposes, such as charitable, educational or scientific purposes

An organization may be described in § 501(c)(3) of the Code and its income may also be excluded from gross income under § 115(1). See Treas. Reg. § 1.6033-2(g)(1)(v) (a state institution exempt from taxation under § 501(a) the income of which is excluded from gross income under § 115(a) (now § 115(1)) is not required to file an annual information return on Form 990, *Return of Organization Exempt From Income Tax*); see also Rev. Proc. 95-48, §§ 3.01, 4.02, 1995-2 C.B. 418.

For purposes of obtaining a ruling from the Service under § 115(1)[6], a § 501(c)(3) organization will not satisfy § 115's accrual test unless its articles of organization also limit distribution of assets on dissolution to one or more States, political subdivisions of States, the District of Columbia, or other organizations the income of which is excluded under § 115(1). For purposes of obtaining a § 115(1) ruling, the organization may not rely on a provision of state law to satisfy the distribution of assets upon dissolution requirement of section 115(1). See Rev. Proc. 2003-12, 2003-1 C.B. 316.

Instrumentality

The Code makes multiple references to instrumentalities of state or local governments, but there is no definition of instrumentality in the Code. As discussed above, Rev. Rul. 57-128, 1957-1 C.B. 311, an employment tax ruling, provides a six-factor test for status as an instrumentality for employment tax purposes. The six-factor test has also been used to determine whether an entity is a state or local government instrumentality for other purposes, including whether it was eligible to receive deductible charitable contributions under § 170, see Rev. Rul. 75-359, 1975-2 C.B. 79, (voluntary association of counties qualified as wholly owned instrumentality of the member counties) and whether it was an instrumentality meeting the definition of a governmental unit for purposes of § 103 and § 141, see PLR 200339035 (company created by a political subdivision for the purpose of assisting with provision of electric energy to its political subdivision members qualified as instrumentality).

A test similar to the six-factor test is applied in cases involving § 414(d) of the Code to determine whether a retirement plan is a governmental plan within the meaning of that

[6] Note that an organization is not required to obtain a ruling from the Service to assert that its income is excludable under § 115.

Code section. The test is set forth in Rev. Rul. 89-49, 1989-1 C.B. 117, and contains the following four 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.

Although the § 414(d) test lists four factors rather than six, it too focuses on governance and control along with funding as key criteria for distinguishing a governmental entity from a nongovernmental entity. It has been applied in a number of private letter rulings. See, e.g., PLR 200216035 and PLR 200339055.

Integral Part

The term "integral part" of a state or local government does not appear in the Code. It does appear a few times in the regulations, but it is not defined. Treas. Reg. § 301.7701-1(a)(3) references integral part, stating that "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." Additionally, Treas. Reg. § 1.892-2T(a)(2) defines integral part for foreign governments. Governments have sought the rulings where they have created a trust or corporation to perform a function but the entity does not have the sovereign powers that make it a political subdivision and also fails the accrual test under § 115 because of actual or potential accrual of income to non-governmental parties.

The approach taken in analyzing an integral part case also borrows the six-factor test from Rev. Rul. 57-128, but emphasizes two factors: control and financing. [redacted] DP

Existing Dual Character Guidance

The issue of dual status arises in two contexts—either a currently recognized government entity wants the additional § 501(c)(3) status, or a currently recognized § 501(c)(3) organization wants the additional government entity status. For examples of the first context, see revenue rulings 55-319 and 60-384 (both discussed infra). For an example of the second context, see CCA 199927036 (considering the issue of whether a § 501(c)(3) organization—a "regional center"—was "an agency of a State or political subdivision thereof" for purposes of § 131).

There are numerous reasons that result in entities having dual character, and in a variety of contexts. Not all motivators are tax related. See, e.g., SEC No-Action Letter at 1986 WL 65168 (since certain governmental units are functionally equivalent to tax

exempt organizations described in § 501(c)(3), they may also be deemed to be accredited investors for purposes of Rules 215(c) and 501(a)(3) of the Securities Act of 1933).

Rev. Rul. 55-319. Rev. Rul. 55-319, 1955-1 C.B. 119, addresses the question of whether a wholly-owned State instrumentality can also qualify for exemption from Federal income tax under § 501(c)(3). This ruling holds, in part, that where an organization desires to have the benefit of a particular tax feature extended to its employees, which depends on exemption under § 501(a) of an employer described in § 501(c)(3), and the organization meets the requirements for exemption under § 501(c)(3), then it may be granted such exemption regardless of the fact that it also qualifies as a wholly-owned State instrumentality and, as such, would be exempt from Federal income tax.

Rev. Rul. 60-384. Rev. Rul. 60-384, 1960-2 C.B. 172, amplifies Rev. Rul. 55-319. Rev. Rul. 60-384 explains that a state or municipality itself would not qualify as an organization described in § 501(c)(3) since its purposes are clearly not exclusively those described in § 501(c)(3). Further, where a particular branch or department under whose jurisdiction the activity in question is being conducted is an integral part of a state or municipal government, the provisions of § 501(c)(3) would not be applicable.

However, a wholly-owned state or municipal instrumentality that is a counterpart of an organization described in § 501(c)(3), such as a separately organized school, college, university or hospital, may qualify for exemption under § 501(c)(3). Nevertheless, if the organization conducting the activity, although a separate entity, is clothed with powers other than those described in § 501(c)(3) it would not be a clear counterpart of a § 501(c)(3) organization. For example, where a wholly-owned state or municipal instrumentality exercises enforcement or regulatory powers in the public interest such as health, welfare, or safety, it would not be a clear counterpart of a § 501(c)(3) organization even though separately organized since it has purposes or powers which are beyond those described in § 501(c)(3).

While the basis for the distinction made in Rev. Rul. 60-384 has not met with approval from the Tax Court, the underlying position that an entity may hold a dual character status has. See Estate of Green v. Commissioner, 82 T.C. 843 (1984). Further, Rev. Rul. 60-384, which holds that a wholly-owned instrumentality may also be a § 501(c)(3) organization, remains the official position of the Service.

Conclusions and Recommendations

It is the long-standing position of the Service that taxpayers may be both a government entity and an organization exempt under § 501(a) and described in § 501(c), if separately qualified for each. Accordingly, the question is not whether a taxpayer is a government entity or a § 501(c)(3) organization. Rather, determining a taxpayer's status must involve a tax-provision specific inquiry. For example, determining a

taxpayer's status for employment tax purposes may require asking whether, for purposes of § 3121(b)(7), the taxpayer is a government entity.[7] For other tax provisions, the taxpayer may hold a different status, such as that under § 501(c)(3).

There is no authority to force a taxpayer to choose the same status for all federal tax purposes. [redacted] We fully recognize that similar terms are used in different contexts, with different meanings depending on the context. For example, the legal standards of Rev. Proc. 95-48 and § 115 bear little resemblance to the six-factor employment tax standard in Rev. Rul. 57-128.

As for resolving conflicts arising due to a taxpayer's dual character, we encourage you to provide to us representative case scenarios illustrating any conflicts. It would also be helpful for us to know the approximate number of current audits each scenario represents. A source of inventory that may raise dual status issues involving a single taxpayer may be taxpayers applying for a ruling under Rev. Proc. 95-48 to determine if they are "governmental units" or "affiliates of governmental units" for purposes of an exemption from filing Form 990.

We understand that the single digit employment code field in various IRS computer systems is not currently designed to reflect the long-standing position of the Service that taxpayers may be both a government entity and an organization exempt under § 501(a) and described in § 501(c). We encourage your continuing efforts for programming solutions that would allow this information to be captured.

Finally, we understand that the training materials are scheduled for revision soon. As you work through these, we suggest that you submit your final drafts to Chief Counsel for review, which we will coordinate.

Please contact us if you have any questions about this memorandum.

Cc: Sunita Lough, Director, FSLG
Catherine Livingston, Deputy Division Counsel/Deputy Associate Chief Counsel (Exempt Organization/Employment Tax/Government Entities)

[7] The "government entity" standard for § 3121(b)(7) purposes technically requires a determination whether the services in issue were performed by an employee "of a State, or any political subdivision thereof, or any instrumentality of one or more of the foregoing, which is wholly owned thereby."