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IRS LTR: Nonprofit's Income Is Exempt as Exercise of Essential Government Function.

The IRS ruled that the income of a corporation formed by a state political subdivision to operate and maintain public terminals and warehouses is derived from the exercise of an essential governmental function and is excludable from gross income under section 115(1).

Citations: LTR 201346006

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Refer Reply To: CC:TEGE:EOEG:EO – PLR-117177-13

Dear * * *:

This letter responds to a letter from your authorized representative dated April 4, 2013, requesting a ruling that Company's income is excludable from gross income under Internal Revenue Code ("IRC") § 115. Company represents the facts as follows.

FACTS

Company was formed on Date 1, by Authority, a political subdivision of State, to operate Facilities as they then existed and have subsequently been expanded. Its articles provide that it is "to operate, maintain, develop and improve the public terminal and warehouse facilities of the ports of the [State]" and "to foster the development of the foreign commerce of the United States and the ports of the [State]." The members of Company's board of directors are selected by the Board of Authority, with the executive director of the Authority serving as a permanent member. Authority's Board has the authority to remove and replace any member of Company's board of directors. Company's board of directors appoints all officers of Company.

Upon dissolution of Company all of its net assts shall be distributed to Authority. Company's articles further provide that no part of its net earning shall inure to the benefit of, or be distributable to its directors, officers, or other private persons.

Authority and Company are parties to a service agreement that provides that Company will manage, operate and conduct the business of the Facilities in accordance with the policies established by Authority's Board and the Statute. Pursuant to the agreement Authority has delegated to Company the authority to establish rates, charges, regulations, tariffs, practices and requirements concerning the use of the Facilities. However, Authority retains the right to review and revise all such rates and charges. Under the agreement all gross revenues collected by Company, less its expenses must be paid to Authority.

On Date 2, the Internal Revenue Service ("Service") issued Company a letter ruling concluding that Company's income is excludable from gross income under IRC § 115. Company's activities serve the good of the general public by having central management for state-owned facilities. On Date 3, the Service issued Company a subsequent letter ruling concluding that certain changes in Company's operations would not affect the ruling contained in the Date 2 letter.

Company plans to convert from a nonprofit, non-stock corporation to a limited liability company pursuant to the laws of State. Company will be treated as a corporation for federal tax purposes following the conversion. Authority will hold the sole membership in Company. The purpose of the conversion is to streamline, modernize and make more efficient the operations of both entities and to give more oversight and control of Company's activities to Authority.

After the conversion, Authority will continue to receive all net revenues attributable to Company's operations. Additionally, any liquidation proceeds upon a termination of Company would be distributed exclusively to Authority.

Company has two wholly-owned subsidiaries, Subsidiary 1 and Subsidiary 2. Subsidiary 1 owns X, which enables certain cargo to be transported to, from and between the public terminal and warehouse facilities of the ports of State. Subsidiary 2 has acted as manager of Subsidiary 1 and the operator of X. Both subsidiaries are limited liability companies and are disregarded entities for federal tax purposes. In connection with the proposed conversion, Subsidiary 2 will merge into Subsidiary 1 and Subsidiary 1 will take over the duties of Subsidiary 2 to manage and operate X.

LAW AND ANALYSIS

IRC § 115(1) 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.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that income generated by an investment fund that is established by a state to hold revenues in excess of the amounts needed to meet current expenses is excludable from gross income under IRC § 115(1), because such investment constitutes an essential governmental function. The ruling explains that the statutory exclusion is intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of an entity engaged in the operation of a public utility or the performance of some governmental function that accrues to either a state or political subdivision of a state. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and that are within the ambit of a sovereign to conduct.

Rev. Rul. 90-74, 1990-2 C.B. 34, holds that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (e.g., casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under IRC § 115(1) because the organization is performing an essential governmental function. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Company operates, maintains, develops and improves the public terminal and warehouse facilities of the ports of State. That function constitutes the performance of an essential governmental function within the meaning of IRC § 115(1). See Rev. Rul. 77-261 and Rev. Rul. 90-74.

In addition, all the net revenue of Company accrues to Authority. No private interests participate in

or benefit from the operation of Company, other than incidentally or as providers of goods or services. Company dedicates its assets and income exclusively for the benefit of Authority. See Rev. Rul. 90-74.

All of Company's assets that remain upon dissolution of Company (after providing for all outstanding obligations) will be distributed to Authority, which is a political subdivision of the State. See Rev. Rul. 90-74.

Based on the information and representations submitted on behalf of Company, we conclude that:

The income of Company will derive from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof. Company's income will be excludable from gross income under IRC § 115(1) upon Company's conversion under State law to a single-member limited liability company that is treated as a corporation for federal income tax purposes.

No opinion is expressed concerning the Federal tax consequences under any IRC provision other than the one specifically cited above.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. IRC § 6110(k)(3) provides that it may not be used or cited as precedent.

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Kenneth M. Griffin

Chief, EO Branch

(Tax Exempt & Government Entities)

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