

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

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## **IRS LTR: Income Exempt as Exercise of Essential Government Function.**

The IRS ruled that the income of an authority that was formed by a county and a state political subdivision and that receives revenues from the sale of electrical energy is derived from the exercise of an essential governmental function and that the authority is a constituted authority under reg. section 1.103-1(b).

Citations: LTR 201442037

Third Party Communication: None  
Date of Communication: Not Applicable  
Person To Contact: \*\*\*, ID No. \*\*\*  
Telephone Number: \*\*\*

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### LEGEND:

Act = \*\*\*  
Agreement = \*\*\*  
Authority = \*\*\*  
State = \*\*\*  
County = \*\*\*  
Agency = \*\*\*  
Project = \*\*\*  
Statutes = \*\*\*  
x = \*\*\*

Dear \*\*\*:

This letter is in response to your request for rulings that (1) the Authority's income is derived from the exercise of an essential governmental function and will accrue to the State or a political subdivision thereof for purposes of § 115(1) of the Internal Revenue Code; and (2) the Authority is a constituted authority within the meaning of § 1.103-1(b) of the Income Tax Regulations.

### FACTS AND REPRESENTATIONS

The County is a political subdivision of the State. The Agency was created by the Act as a body politic and corporate. The Agency is empowered by the Act to undertake any lawful act necessary to ensure sufficient water for the present and future beneficial use of the land and inhabitants within

County. The Authority represents that Agency is a political subdivision of the State.

The Agency owns the Project, which consists of hydroelectric power plants, dams, tunnels, and public recreational facilities. The Agency operates the Project pursuant to a license issued by the Federal Energy Regulatory Commission (FERC).

Pursuant to the Statutes, the County and the Agency entered into the Agreement creating the Authority. The Agreement authorizes the Authority to exercise the powers of each of the County and the Agency. The purpose of the Authority is to provide financing for costs required by the FERC licensing process, to approve electrical energy and related services contracts, and to distribute revenues from those contracts. Among the powers the Authority can exercise in furtherance of these purposes are the powers to acquire, to lease, and to sell property. The Agreement and the Statutes authorize the Authority to issue bonds.

The County and the Agency are the sole members of the Authority. The Authority is governed by a x member board of directors. Half of those directors are members of the County's board of directors, and half are members of the Agency's board of directors.

The Agreement provides that the Authority receives all revenues from the sale of electrical energy produced by the Project. The Agreement also establishes priorities for the expenditure and distribution of those revenues. Under the Agreement, revenues must first be spent on basic operation and maintenance of the Project, compliance with contractual and regulatory requirements, maintenance of operating reserves, and repayment of debt. After those costs are paid, revenues must then be spent on additions and betterments, such as major improvements, emergency reserves, and sinking funds for replacements. Finally, any remaining revenues may be distributed equally to the County and the Agency. Upon dissolution, the Authority's property will be divided between the County and the Agency.

## LAW AND ANALYSIS

### Income under § 115

Section 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.

In Revenue Ruling 77-261, 1977-2 C.B. 45, income from an investment fund, established by a state under a written declaration of trust for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under § 115(1). The ruling explains that the statutory exclusion was 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 a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrues to either a state or municipality. 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 which are within the ambit of a sovereign properly to conduct.

In Revenue Ruling 90-74, 1990-2 C.B. 34, the income of an organization formed, funded, and operated by political subdivisions to pool various risks arising from their obligations regarding public liability, workers' compensation, or employees' health was excludable from gross income under § 115. In this ruling, private interests did not participate in the organization, nor did they benefit more than incidentally from the organization.

The Authority reviews and approves contracts for the sale of electrical energy generated by the Project, distributes revenues from those contracts, and provides financing for costs required by the FERC licensing process. Engaging in such activities on behalf of the County and the Agency constitutes the performance of essential governmental functions. See Rev. Rul. 90-74 and Rev. Rul. 77-261.

All of the Authority's income accrues to the County and the Agency, which are political subdivisions of the State. Revenues exceeding amounts necessary for the operation, maintenance, and support of the Project and for additions and betterments to the Project are distributed to the County and the Agency. Upon the Authority's dissolution, all of its property will be divided between the County and the Agency. No private interests participate in, or benefit more than incidentally from, the operation of the Authority, other than as providers of goods or services or purchasers of electrical energy. See Rev. Rul. 90-74. We conclude, therefore, that the Authority's income is derived from the exercise of an essential governmental function and will accrue to the State or a political subdivision thereof for purposes of § 115(1).

#### Constituted Authority

Section 103(a) provides that gross income does not include interest on any state or local bond. Treas. Reg. § 1.103-1(a) provides in part that interest upon obligations of a state, territory, possession of the United States, the District of Columbia, or any political subdivision thereof is not includable in gross income. Treas. Reg. § 1.103-1(b) provides in part that obligations issued by or on behalf of any such governmental unit by a constituted authority empowered to issue such an obligation are the obligations of such a unit.

Revenue Ruling 57-187, 1957-1 C.B. 65, holds that bonds issued by an entity are considered issued on behalf of a political subdivision of the state under the following conditions: (1) the issuance of bonds is authorized by a specific state statute; (2) the bond issuance has a public purpose; (3) the governing body of the entity is controlled by the political subdivision; (4) the entity has the power to acquire, lease, and sell property and issue bonds in furtherance of its purposes; (5) earnings do not inure to the benefit of private persons; and (6) upon dissolution, title to all bond-financed property reverts to the political subdivision.

The Agreement and the Statutes authorize the Authority to issue bonds, and its issuances are for the public purpose of financing costs required by the FERC licensing process. The County and the Agency, which are political subdivisions, control the Authority's governing board. The Agreement empowers the Authority to acquire, lease, and sell property and to issue bonds in furtherance of its public purposes. Earnings of the Authority inure solely to the benefit of the County and the Agency. Upon the Authority's dissolution, all of its property reverts to the County and the Agency. We conclude, therefore, that the Authority is a constituted authority within the meaning of Treas. Reg. § 1.103-1(b).

#### CONCLUSION

Based on the information submitted and representations made, we conclude that (1) the Authority's income is derived from the exercise of an essential governmental function and will accrue to the State or a political subdivision thereof for purposes of § 115(1); and (2) the Authority is a constituted authority within the meaning of Treas. Reg. § 1.103-1(b).

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. Section 6110(k)(3) of the Code 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.

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,

James A. Polfer  
Branch Chief  
(Financial Institutions & Products)

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