Internal Revenue Service

Department of the Treasury

Index Number: 115.00-00

Washington, DC 20224

199903034

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:3/PLR-119469-97

Date:
AUG 27 1998

LEGEND:

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Utility =
Commission =
Department =
District =

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Dear

This is in response to a letter dated October 15, 1997, and subsequent correspondence requesting (1) a ruling concerning the exclusion of income of Utility from gross income under section 115 of the Internal Revenue Code, and (2) a ruling that section 337(d) of the Code does not require recognition of gain or loss by Utility as a result of the proposed transaction.

FACTS

Utility is currently a for-profit stock corporation incorporated under the laws of the State and regulated by the Commission. Utility provides water service for most areas of the Town. The Town has experienced a rapid growth in population.

Utility currently provides water from wells that tap into a local aquifer. The aquifer is also used by a large adjacent municipality, mostly as an emergency source of water. The aquifer has been seriously depleted and the pumping capacity of

Utility has been drastically reduced. A number of studies indicate that at current rates of pumping the aquifer will probably run out of water within the next B years if another source of water is not used. In the event of a prolonged drought or problems with the neighboring municipality's surface water supply, the aquifer will be depleted even faster.

The Department has recommended that the Town use surface water in order to assure an adequate water supply and to reduce pressure on the aquifer. The Department will not grant certificates of assured water supply unless surface water is used. Three small developments are currently suspended due to the lack of certificates of assured water supply.

Utility currently has permission to use up to C of surface water but makes little use of this water due to lack of infrastructure. The Department has determined that the Town needs D of surface water to have an assured water supply.

Utility would like to build a pipeline to the source of surface water. Due to Commission limits on water rates, Utility has insufficient revenue to pay for the pipeline unless water rates are increased. However, the Commission will not authorize an increase in water rates until after Utility has built the pipeline and begun to use surface water. In addition, Utility may need additional infrastructure to use D of surface water and would have the same funding problems.

If Utility is owned by a political subdivision of the State, like the Town, Utility would no longer be subject to the Commission limits on water rates. Utility could then increase water rates to pay for the pipeline or any other infrastructure needed in the future. However, the State Constitution bars the Town from being a shareholder in any corporation.

Due to the constitutional restriction, the Town considered different approaches to obtaining the assets of Utility. The conventional method contemplated by state legislation involves the use of eminent domain proceedings. However, the estimated $ E cost of purchasing Utility's assets through condemnation would require more than quadrupling current water rates before even considering the increases needed to enable construction of the surface water pipeline.

In arms length negotiations, the shareholders of Utility have indicated that they are willing to sell all the capital stock in Utility for $ F. By purchasing Utility intact, the Town

may also avoid certain problems concerning the transferability of water rights owned by Utility.

The Town proposes the following transactions:

(i) The Town will establish the District.

(ii) The District will issue debt obligations (the Purchase Debt), the proceeds of sale from which will be used to finance the purchase by the District of Utility. The acquisition by the District of all of the stock of Utility will be effected pursuant to a stock purchase agreement. The purchase price will be $ F.

Additionally, Utility represents that it will amend its articles of incorporation (articles) so that all of Utility's net earnings will be distributable only to the District or another political subdivision of the State specified by Utility's board of directors. The proposed articles also will provide that no earnings or assets of Utility will inure to the benefit of, or be distributed to, any private person, except that reasonable compensation may be paid by Utility and Utility may expend funds in furtherance of its activities as a public utility. Finally, the articles will provide that, in the event of Utility's dissolution, all of its assets, after payment of its debts and obligations, will be distributed to the District or another political subdivision of the State specified by Utility's board of directors.

The District will be managed by a board of directors all of the members of which will be members of the governing body of the Town, acting ex officio. Pursuant to State law, the District will possess the power to levy an ad valorem tax to pay for any general obligation bonds issued by the District. In addition, State law provides that the District, for public infrastructure purposes, may exercise the power of eminent domain in a manner similar to the state, a county, city, town, village, or political subdivision except that the District may not condemn federal, state, county, or political subdivision property.

Utility's board of directors will be composed of the members of the District's board of directors. Through its status as the sole shareholder of Utility and its board of directors, the District will be responsible for the management and operation of Utility. Utility will continue to derive its revenue from the sale of water to its customers, development fees, and utility hookups. Utility's revenues will be used first to pay the

current operating costs and maintenance of the System, then to pay debt service with respect to the Purchase Debt and other debt of the District issued to expand and improve the System (including to accumulate reserves for payment of such debt service), and then to accumulate reserves for renewal and repair of the System and eventual improvement and expansion of the System. All debt instruments issued by the District to improve or expand the System will be payable exclusively from System revenues, developer exactions (as described below), or special assessments against property within the service area.

Utility represents that neither the State nor any political subdivision thereof has provided any direct or indirect payment or other financial contribution or commitment to or on behalf of Utility, whether in the form of cash, property, services, guarantees, assumptions, or otherwise (any such direct or indirect payment or other financial contribution or commitment to or on behalf of Utility being referred to as Financial Support) within the year immediately preceding Utility's acquisition by the District.

The Town represents, in relevant part, that:

(a) The Purchase Debt is nonrecourse, i.e., without recourse to the general assets of the District and the Town and is secured only by a pledge of, and payable from, Utility's assets and revenues derived from Utility's assets (such pledged items being referred to collectively as the Collateral).

(b) No deficiency judgment may be rendered against the State or any agency or instrumentality thereof, including the District and the Town, for any amounts due on the Purchase Debt that are not paid from the proceeds of the Collateral. The Act provides that the bonds, notes, and other obligations of the District (including the Purchase Debt) shall not be a debt of the State or any political subdivision thereof and that neither the credit, the revenues, nor the taxing power of the State or any political subdivision thereof shall be, or shall be deemed to be, pledged to the payment of such bonds, notes, and other obligations.

(c) The terms and conditions of the Purchase Debt will be designed to ensure that (i) all payments of principal and interest due thereon will be fully funded in a timely manner from the Collateral, and (ii) neither

the State nor any political subdivision thereof will provide any additional funding for payment of such principal and interest in addition to the Collateral.

(d) The District reasonably expects that (i) all of Utility's costs of operating and maintaining its business, including the costs of necessary or appropriate capital improvements, will be fully funded from the revenues of Utility, and (ii) neither the State nor any political subdivision thereof will provide any other funds for the reasonable foreseeable operation, maintenance, capital, or other expenditures of Utility.

(e) The District expects that its operating policies and those of Utility will provide that (i) any expansion of or addition to the business and assets of Utility will be funded either by Utility through its own financing, by the developers of newly built properties, or by special assessment of existing property owners, so that neither the State nor any political subdivision thereof would be providing funds for expansion, and (ii) any expansion of or addition to water service within Utility's service area that the State or any political subdivision thereof chooses to fund will be effected outside Utility and any such expansion or addition will not be owned by Utility.

(f) The District reasonably expects that neither the State nor any political subdivision thereof will provide within five years after the acquisition of Utility by the District any Financial Support to Utility.

(g) The District intends to establish the rates to be charged by Utility for public water utility service at a level that will be sufficient only (i) to pay (1) Utility's public water utility service debt service costs and debt service on the Purchase Debt (and other debt of the District issued to improve and expand the System), (2) the costs of operating and maintaining Utility's public water utility service assets, and (3) capital expenditures for renewals, replacements, and additional public water utility service facilities or assets which either are located within Utility's service area or, if they are not located in Utility's service area, are reasonably

necessary to satisfy Utility's (statutory) obligation to provide public water utility service in the service area, and (ii) to maintain working capital and other reserves consistent with the reasonable needs of Utility's public water utility service.

For purposes of the foregoing representations:

(i) Financial Support includes any direct or indirect payment or other financial contribution or commitment to or on behalf of Utility, whether in the form of cash, property, services, guarantees, assumptions, or otherwise.

(ii) Financial Support does not include any goods or services for which Utility pays reasonable consideration, including, without limitation, purchases from the Town or the District for which Utility pays reasonable consideration.

(iii) Financial Support does not include economic incentives or subsidies provided by the State or any political subdivision thereof directly to individuals or entities that are connecting or connected to the System, provided that any such amounts paid over to Utility are for connection charges and not to benefit Utility as a whole.

LAW AND ANALYSIS

Ruling 1:

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 political subdivision of a state.

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. When a state or political subdivision conducts an enterprise through a separate entity (i.e., an entity that is not considered an integral part of the state or political subdivision), however, the income of the entity may be exempt or excluded from income under a specific provision such as § 501 or § 115.

In Maryland Savings-Share Ins. Corp. v. United States, 308 F. Supp. 761 (D. Md. 1970), 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 Michigan 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 the 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 the state.

Nevertheless, in determining whether an enterprise is an integral part of the state, it is necessary to consider all of the facts and circumstances, including the state's financial commitment to the enterprise and the state's degree of control over 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 recognized as separate from a state or political subdivision for local law purposes 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. . .

If Utility is determined to be an integral part of the State, Town, or the District as a result of the transactions described above, § 115 will not apply to the income of Utility. The first factor in determining Utility's status following the acquisition by the District is whether there is or will be a significant financial commitment to Utility by the State or a political subdivision of the State.

For Utility to be considered an integral part of the State or a political subdivision of the State, Utility must receive a substantial financial commitment from the State, either directly or through or a political subdivision thereof. The acquisition of Utility will be financed with Purchase Debt, which is without

recourse to the general assets of the District and the Town and is secured only by a pledge of, and payable from, Utility's assets and revenues derived from Utility's assets. Further, the District and the Town represent that they do not reasonably expect to contribute (or commit to contribute) Financial Support to Utility during the five-year period beginning on the date of the acquisition of Utility by the District, taking into account the form of any monetary support and the fair value of any non-monetary support in whatever form provided. The Purchase Debt and any additional debt incurred for expansion will be fully funded from Utility revenues. Utility also represents that it has not received any payment or financial support or commitment from the State or any political subdivision thereof during the year prior to the acquisition of Utility by the District.

The economic incentives offered to end users by the Town are subsidies intended to reduce development costs of commercial enterprises and thereby promote economic development in Town. The subsidies do not financially benefit Utility or the System as a whole, but rather primarily benefit the recipient of the incentive, and thus will not be considered Financial Support in determining whether Utility is an integral part of the District or the Town.

Accordingly, after considering the cumulative financial contributions that the State, Town and District have made or intend to make to Utility, Utility has not received and will not receive a substantial financial commitment from the State or a political subdivision thereof. Therefore, Utility will not meet the financial commitment requirement of the integral part test.

Because we have determined that there is no substantial financial commitment from the State or a political subdivision thereof, we do not address whether Utility would meet the state control factor for integral part status.

Having concluded that Utility is not an integral part of the State or any political subdivision, we now look to the factors (to determine whether its income may be excludable from gross income) under § 115(1).

Rev. Rul. 57-151, 1957-1 C.B. 64, concludes that the income earned by a trust created to provide utility services such as water supply, fire protection, and sewage disposal was not subject to federal income tax. No funds of the trust could be diverted to any private use and, upon termination of the trust, after payment of all debts and obligations, the remainder of the

trust assets would be distributed to the board of county commissioners.

The term "political subdivision" is not defined in the Code. However, the interpretation of "political subdivision" contained in § 1.103-1(b) of the Income Tax Regulations for purposes of § 103 has been used to define the term for purposes of other Code sections. Section 1.103-1(b) provides that the term "political subdivision" denotes any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. The three generally acknowledged sovereign powers are the power to tax, the power of eminent domain, and the police power. See Commissioner v. Estate of Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). It is not necessary that all three of these powers be delegated. However, possession of only an insubstantial amount of any or all sovereign powers is not sufficient. Under State law, the District possesses the power to tax and the power of eminent domain. Therefore, we conclude that the District is a political subdivision for federal tax purposes.

Utility is similar to the trust described in Rev. Rul. 57-151. Utility provides water for residential, commercial, and industrial use as well as for fire protection and other municipal services in Town. Under the proposed Articles, no earnings or assets of Utility may inure to the benefit of any private person. Upon dissolution, after payment of all debts and obligations, all remaining assets will be distributed to District or another political subdivision of the State. Additionally, Utility is under the control of the District, a political subdivision of the State. Therefore, we conclude that Utility is a public utility for purposes of § 115(1) and any income derived from the water utility service operations and activities of Utility following the acquisition by the District will accrue to a political subdivision of the State. Accordingly, that income will be excludable from gross income under § 115(1).

This ruling presumes that 100% of the ownership of the Utility will be held by the District. If the Utility issues additional stock, it must be held by the District, Town, State, a political subdivision of State, or an entity that itself qualifies to exclude income from gross income under § 115. In addition, only Town, State, a political subdivision of State, or an entity that itself qualifies to exclude income from gross income under § 115 may receive a transfer of any portion of the ownership of the Utility .

We note that §§ 6012(a)(2) and 1.6012-2(a)(1) provide, in general, that every corporation, as defined in § 7701(a)(3), subject to taxation under subtitle A is required to file an income tax return regardless of whether it has taxable income and regardless of its gross income. Accordingly, Utility will be required to continue to file income tax returns pursuant to § 6012(a)(2).

Ruling 2:

Based on the information submitted and the representations set forth above, which information and representations were accompanied by penalties of perjury statements executed by the appropriate party or parties, we rule that the Town, the District, and Utility will not recognize gain pursuant to § 336 or § 337 or any other Code provision (i) upon the District's purchase of Utility's stock or (ii) by reason of Utility's subsequent exclusion of income under § 115.

If the facts and circumstances in the future are other than as contemplated by the foregoing representations (e.g., the nature of incentives offered or sponsored by the State or political subdivisions thereof differs materially in kind or extent from prior incentives), the Town, the District, and Utility should seek an appropriate supplemental ruling from the Internal Revenue Service with respect to the presence or absence of Financial Support for Utility and the effect thereof on the status of Utility (and the original ruling).

No opinion is expressed about the following issues:

1. The tax treatment of the proposed transaction under other provisions of the Code and Regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.
2. The tax treatment of future actual or constructive dispositions of assets by Utility, including the application of § 1245 or § 1250.
3. Whether income from the sale or other disposition after the District's acquisition of the Utility of property held by Utility prior to the District's acquisition of the Utility is excluded under § 115.
4. Whether interest on debt incurred by the District to purchase Utility is excludable under § 103(a).

Proposed regulations under § 337(d) have been issued that apply to transactions in which a taxable corporation's income becomes exempt from tax under § 115. See Prop. Treas. Reg. § 1.337(d)-4. If those regulations are issued and become effective as final regulations before the proposed transaction is consummated, those regulations may affect the ruling expressed herein and the tax treatment of the proposed transaction.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

In accordance with the powers of attorney on file in this office, copies of this letter are being sent to your authorized representatives.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and Products)

By: Alice M. Bennett
Alice M. Bennett
Chief, Branch 3

enclosures: Copy of this letter
Copy for section 6110 purposes