

# A BROADER TAX EXEMPTION— EXCLUDING INCOME RELATED TO GOVERNMENTAL FUNCTIONS

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There is a little-known section of the Code that excludes almost all revenue from the definition of "gross income." Moreover, if the revenue of an exempt organization qualifies for exclusion under this provision, the organization can be exempt from filing annual Forms 990. The exclusion provided by this rarely used Code section covers a much broader scope of revenue than the exclusion from the definition of unrelated business income, and it is easier for qualifying organizations to obtain recognition of such qualification than it is to obtain tax-exempt status. Finally, even if an organization's exemption is revoked by the Service, the exclusion of revenue from the definition of gross income may remain intact.

Section 115(1) provides that gross income for federal income tax purposes does not include "income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof." This means that any income that an organization earns from performing an essential governmental function is excluded from the definition of gross income to the extent that it accrues to a state or any political subsidiary, which essentially eliminates any concerns re-

garding whether income derived from an activity may be subject to tax as unrelated business income.

While it is clear that the Section 115(1) exclusion can provide substantial benefits to a variety of organizations, few organizations take advantage of it and few tax advisors are aware of it or its substantial benefits. In fact, when the author has discussed the Section 115 exclusion with clients, in almost every instance they have asked: "What is Section 115?"

## What is Section 115(1)?

It is a long-standing rule that "[i]ncome earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state is generally not taxable in the absence of specific statutory authorization for taxing such income."<sup>1</sup> This exclusion is limited to income that is directly earned by states and political subdivisions and is generally not available to independent entities established by states or political subdivisions to engage in activities on their behalf. "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 section 501 and section 115."<sup>2</sup>

Section 115 broadens the spectrum of income-generating activities in which an exempt organization may engage without incurring any additional tax liability.

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Section 115(1) provides that gross income for purposes of taxation 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." Thus, to be excluded from taxable gross income under Section 115, an entity's income (1) must be derived from an essential governmental function, and (2) must accrue to a state or political subdivision.

The Section 115(1) exclusion differs from the general exclusion applicable to states, their political subdivisions, and integral parts of states and their political subdivisions. Specifically, the Service has said that Section 115 "does not apply to the states directly or to their political subdivisions, such as counties, cities, or towns."<sup>3</sup> Thus, in determining whether an entity's income is excluded under Section 115, the Service requires that entity not to be a state, a political subdivision of a state, or an integral part of a state or political subdivision. Rather, the Service has said that "Section 115 of the Code applies to organizations that are separate entities, that is, it applies to organizations that are not a part of the government of a state or a political subdivision of a state."<sup>4</sup> Also, there is no requirement that an organization be created by or controlled by a state or political subdivision to avail itself of the Section 115 exclusion. In fact, if a state or political subdivision has too much control, the organization may not be able to qualify for the Section 115 exclusion.

Similarly, a state or municipality itself does not qualify as an organization of the type described in Section 501(c)(3), and "an activity constituting an integral part of a state or mu-

nicipal government cannot so qualify inasmuch as the organization engaged therein would still be the state or municipal government."<sup>5</sup> "On the other hand, a wholly-owned state or municipal instrumentality which is a counterpart of an organization described in section 501(c)(3) of the Code such as a separately organized school, college, university, or hospital may qualify for exemption under section 501(c)(3)."<sup>6</sup> Thus, to be recognized as exempt under Section 501(a) or to qualify for the exclusion of Section 115, an organization must be independent of a state or political subdivision. An analysis of whether an organization qualifies for the exclusion in Section 115(1) therefore does not look to whether an organization is a state or political subdivision, but instead focuses on whether the organization is performing an essential governmental function and whether its income accrues to the benefit of a state or political subdivision.

The questions that must be answered then are (1) what is "an essential governmental function," and (2) how does "income accrue to a state or political subdivision"?

**Essential governmental function.** The Service and the courts have interpreted "essential governmental function" to include a vast array of activities, including the association's specific activities. The activities that have been deemed to be non-taxable essential governmental functions are as widely varied as operating liquor stores and managing investments. A few examples of the types of activities that the Service has characterized as essential governmental functions include:

- Operation of liquor stores by state entities.<sup>7</sup>
- Operation of a ferry<sup>8</sup> and a toll bridge.<sup>9</sup>

<sup>1</sup> Rev. Rul. 87-2, 1987-1 CB 18.

<sup>2</sup> Ltr. Rul. 199923029. See also Ltr. Rul. 9822011.

<sup>3</sup> Ltr. Rul. 9340038. See also Ltr. Rul. 199923029 ("Because we have concluded that [the taxpayer] is an integral part of State A, section 115 is not applicable").

<sup>4</sup> Ltr. Rul. 9340038.

<sup>5</sup> Rev. Rul. 62-66, 1962-1 CB 83.

<sup>6</sup> Rev. Rul. 60-384, 1960-2 CB 172.

<sup>7</sup> Rev. Rul. 71-131, 1971-1 CB 28; Rev. Rul. 77-132, 1977-1 CB 297.

<sup>8</sup> *Jamestown & Newport Ferry Co.*, 41 F.2d 920, 8 AFTR 11022 (CA-1, 1930).

<sup>9</sup> *Koekuk & Hamilton Bridge, Inc.*, 180 F.2d 58, 38 AFTR 1473 (CA-8, 1950).

<sup>10</sup> Ltr. Rul. 9050052.

<sup>11</sup> Ltr. Rul. 9124010, Ltr. Rul. 9222010, Ltr. Rul. 200127033.

<sup>12</sup> Rev. Rul. 77-261, 1977-2 CB 45.

<sup>13</sup> Ltr. Rul. 200112028.

<sup>14</sup> Ltr. Rul. 199913041.

<sup>15</sup> Ltr. Rul. 199916045.

<sup>16</sup> Ltr. Rul. 9549030.

<sup>17</sup> Ltr. Rul. 200007015.

<sup>18</sup> Ltr. Rul. 200116009.

<sup>19</sup> Ltr. Rul. 9853016.

<sup>20</sup> Ltr. Rul. 199913021.

<sup>21</sup> Rev. Rul. 90-74, 1990-2 CB 34.

<sup>22</sup> Ltr. Rul. 200008024.

<sup>23</sup> Ltr. Rul. 200127033.

<sup>24</sup> Ltr. Rul. 201528010.

<sup>25</sup> Ltr. Rul. 201441003, Ltr. Rul. 201515016.

<sup>26</sup> Rev. Rul. 90-74, *supra* note 21.

<sup>27</sup> Rev. Proc. 2003-12, 2003-1 CB 316.

<sup>28</sup> *City of Woodway*, 681 F.2d 975, 980, 50 AFTR2d 82-5456 (CA-5, 1982).

<sup>29</sup> *City of Bethel*, 594 F.2d 1301, 1302, 43 AFTR2d 79-1090 (CA-9, 1979).

<sup>30</sup> *Id.* at 681 F.2d 1303.

<sup>31</sup> *City of Woodway*, *supra* note 28.

<sup>32</sup> Ltr. Rul. 9017052.

- Activities of an association of county governments operated to address common problems.<sup>10</sup>
- Education.<sup>11</sup>
- Investment and management of cash balances of a state and its political subdivisions.<sup>12</sup>
- Holding and managing loan receivables for a political subdivision.<sup>13</sup>
- Making loans and providing assistance to fund a state's transportation projects.<sup>14</sup>
- Administration of a marketing order to produce agricultural commodities<sup>15</sup> and marketing and management of a county's commercial district.<sup>16</sup>
- Operation of an economic development agency.<sup>17</sup>
- Construction and operation of a convention center hotel,<sup>18</sup> redevelopment of a vacant shopping center,<sup>19</sup> and demolition of an old parking facility and construction of a new parking facility.<sup>20</sup>
- Risk pooling<sup>21</sup> and operation of a group purchasing program.<sup>22</sup>
- Providing general pathology and laboratory testing services<sup>23</sup> and clinical services to a hospital's patients.<sup>24</sup>
- Funding costs of health and welfare benefits for retired city and state employees.<sup>25</sup>

It is notable that the scope of the income items included in the list of activities that the Service has deemed essential governmental functions is much broader than the types of income that may further an organization's exempt purpose, and even includes marketing and making loans, which the Service has historically deemed to be unrelated business activities. Thus, the types of activities that may be excluded from tax as unrelated business income may be much broader for organizations the income of which is excluded from gross income under Section 115(1).

One reason for the variety of activities that the Service has recognized as fulfilling an essential governmental function is that each state government and political subdivision bears the responsibility of determining whether an activity is an essential governmental function. Thus, the Service must interpret the laws of the states and political subdivisions and frequently defers to them to determine what activities accomplish an essential governmental function.

**The income must accrue to the state of the political subsidiary.** For income to be excluded from the definition of gross income pursuant to Section 115(1), in addition to performing an essential governmental function, it must accrue to the benefit of a state or political subsidiary. Generally, to sat-

isfy the accrual requirement, "no private interests participate in or benefit from" the organization's operations, and no private interest can receive distributions of the organization's revenue.<sup>26</sup> The accrual requirement must be satisfied in two ways—on dissolution and presently.

On dissolution, the Service requires that an entity's remaining income from Section 115 activities be distributed to "one or more states, political subdivisions thereof, the District of Columbia, or to other organizations the income of which is excluded from gross income under Code §115."<sup>27</sup> Generally, this requirement is satisfied in a manner similar to passing the organizational test under Section 501(c)(3)—i.e., by including a provision in the organization's governing documents that requires such a distribution on dissolution.

Also, noting that Section 115 excludes only the portion of an entity's income "which actually 'accrues' to the municipal shareholder,"<sup>28</sup> the courts have interpreted the accrual requirement to necessitate the "present accrual of income" to a state or political subdivision. In light of the present accrual requirements, courts have determined that "a right *en futuro* to receive the assets of a corporation upon dissolution cannot be equated to present accrual of income."<sup>29</sup>

Noting that "a corporation's retained earnings do not accrue to a government entity for purposes of section 115(a) even though the corporation's stock is wholly owned by the government entity," courts have required a specific act to demonstrate the accrual of the entity's income to the state or political subsidiary.<sup>30</sup> However, the accrual of income does not necessarily require the physical transfer of assets to a state or political subsidiary; rather, "the requirements of section 115 may be satisfied when there is an accrual of income in an accounting sense."<sup>31</sup>

While the clearest way to demonstrate the present accrual of income to a state or political subsidiary is for an organization to distribute its earnings to a political subdivision, that is not the only way for an organization's income to accrue to a political subdivision. Historically, the Service has determined that an organization's income may accrue to a state or political subdivision when the organization uses its income "to accomplish the essential governmental function" that the entity was created to serve.<sup>32</sup> For instance, the income of an organization that used its income to administer a student loan payment program accrued to the state

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through the performance of the organization's function,<sup>33</sup> and the income of a corporation that operated a procurement program for a state's school districts,<sup>34</sup> were deemed to have satisfied the present accrual requirement through the procurement of goods for and provision of services to its public school members. Similarly, in several rulings, the Service has explained that the income of membership organizations comprising states and political subdivisions accrues to the benefit of the organizations' members when the organizations incur expenses for the benefit of their members.<sup>35</sup> Thus, all amounts that such organizations spend on membership services satisfy the present accrual requirement.

#### **The difference between the Section 115(1) exclusion and the Section 501(a) exemption**

To fully understand the impact of Section 115, it is necessary to understand the differences between Section 115(1) and Section 501(a), which requires focusing on how each section prevents the taxation of certain income.

Section 501(a) provides an exemption from federal income tax for income earned by organizations described in Section 501(c) in the performance of their mission. Thus, in the most basic sense, income that organizations earn is exempt under Section 501(a) only when the income is earned from activities that contribute importantly to the organizations' tax-exempt mission and, although included in gross income, will not be subject to federal income tax. For example, an organization recognized as exempt under Section 501(c)(3) may file a Form 990 that reports millions of dollars in revenue from activities related to its charitable mission without being required to pay any federal income tax on that income; however, any income

derived from a business activity that does not further the organization's charitable purpose may be subject to tax as unrelated business income.

Unlike Section 501(a), Section 115 provides an "exclusion" from the definition of gross income, not an exemption from tax on such income. Thus, if an organization's income consists of income that is described in Section 115(1), it will not report any income as gross income on its annual return. An organization that earns Section 115 income may have millions of dollars in such revenue but will report no gross income on its Form 1120 ("U.S. Corporation Income Tax Return"). Unlike the exemption in Section 501(c), Section 115 relates only to the classification of an entity's revenue and not its operations or mission. Therefore, Section 115 does not require organizations to be recognized as having income exempt under Section 115, and there is no true operational test. As a result, if an organization's income consists of income that is described in Section 115, it cannot lose its Section 115 status by merely engaging in activities that do not serve an essential governmental function. Rather, such an organization will simply be required to report the income as gross income on its annual Service filing.

#### **Organizations may be exempt under section 501(a) and qualify for the Section 115 exclusion**

In the late 1970s and early 1980s, there was a bit of confusion within the Service regarding whether an organization could be a tax-exempt organization and at the same time qualify for the Section 115 exclusion. As a result, there were several examinations that the Service agreed to close only if the organization agreed to relinquish either the recognition of its tax-exempt status under Section 501(a) or the Section 115 income exclusion. The

<sup>33</sup> Ltr. Rul. 201338034.

<sup>34</sup> Ltr. Rul. 200610001.

<sup>35</sup> See Ltr. Rul. 8308029 (income of an association of cities and towns accrued to its municipal members), Ltr. Rul. 9124026 (income of a municipal cooperative association accrued to its members when the association used the income to serve the needs and interests of its members by providing management services, publications, workshops, and group purchasing programs), Ltr. Rul. 9114055 (income of a municipal service league accrued to its members through improved services at reduced costs).

<sup>36</sup> IRM 7.25.3.12.6(3). See also Ltr. Rul. 9017052 (income of an organization exempt under Section 501(c)(3) will be excluded from gross income pursuant to Section 115(1)), Ltr. Rul. 9050052 (income of an organization exempt under Section 501(c)(4) will be excluded from gross income pursuant to Section 115(1)), Ltr. Rul. 200214026 (income of an organization exempt under Section 501(c)(6) will be excluded from

gross income pursuant to Section 115(1)), Ltr. Rul. 200439033 (income of an organization exempt under Section 501(c)(12) will be excluded from gross income pursuant to Section 115(1)).

<sup>37</sup> See also Ltr. Rul. 9017052 (annual information returns are not required to be filed by an organization exempt from taxation under Section 501(c)(3) if it is an organization "the income of which is excluded from gross income under Section 115(1)").

<sup>38</sup> 1995-2 CB 418.

<sup>39</sup> Although a taxable organization may have its income excluded from gross income pursuant to Section 115, it is important for taxable corporations to be aware that, irrespective of their lack of any taxable income, they are required to file annual Forms 1120. The author's firm recently represented a corporation that was unaware of its filing requirement and so failed to file its required Form 1120 for more than 30 years.

Service's confusion on this issue has since been resolved, and it is clearly the Service's current understanding that "[t]he fact that an organization's income may be excluded under IRC 115(1), does not preclude it from also qualifying for exemption under IRC 501(c)(3)."<sup>36</sup>

### The impact of Section 115

The most significant impact of Section 115 is that it eliminates all income derived from essential governmental functions from the definition of gross income. This is significant because of the variety of activities that the Service has recognized as serving an "essential governmental function." Section 115 provides tax-exempt organizations with a broader exemption from income tax than Section 501(a) because many activities that would generally be characterized as unrelated business activities, such as marketing, making loans, or selling alcohol, will be excluded from gross income under Section 115 and so will not be considered to generate taxable income for federal income tax purposes. Thus, Section 115 broadens the spectrum of income-generating activities in which an exempt organization may engage without incurring any additional tax liability. Moreover, any activity that the Service deems to be other than an essential governmental function will nonetheless be exempt from income tax as long as the activity from which the income was derived contributed importantly to the organization's exempt mission.

Another benefit for tax-exempt organizations is that the Section 115 exclusion can be used to eliminate the need to file annual Forms 990. Section 6033(a) generally requires every organization exempt from federal income tax under Section 501(a) to file an annual information return—Form 990. However, Reg. 1.6033-2(g)(1)(v) excludes tax-exempt organizations from this requirement if their income is excluded from gross income under Section 115(1). Therefore, if the Service determines that an organization is exempt under Section 501(a), and that its income is excluded from gross income under Section 115, the organization will not be required to file Form 990.<sup>37</sup> This provides a significant benefit and cost savings as organizations can avoid the time and expense necessary to prepare an annual Form 990.

If an organization's income consists of income that is excluded from gross income pursuant to Section 115(1), it is generally not required to file an annual Form 990 or a Form 990-N (the "e-postcard"). It is important to

note, however, that the Service *does* require organizations to obtain a ruling in order to relieve them of the annual filing requirements. Therefore, to avoid having its exemption automatically revoked for failing to file three successive Forms 990 or Forms 990-N, an organization must obtain a ruling exempting it from the annual Form 990 filing requirements.

Rev. Proc. 95-48<sup>38</sup> generally provides the process for obtaining a ruling that an organization is not required to file an annual Form 990. To obtain such a ruling, an organization must (1) obtain a determination from the Service recognizing the organization as exempt under Section 501(c), which means that organizations that self-certify their tax-exempt status are not eligible to be exempt from the Form 990 reporting requirements; (2) obtain a letter ruling determining that the organization's income is excluded from gross income pursuant to Section 115; and (3) request an exemption from the Form 990 filing requirements by filing a Form 8940 ("Request for Miscellaneous Determination") and including the organization's determination letter and Section 115 ruling. If the Service grants the organization's request, it will not be required to file any future Forms 990.

With the benefits of not being required to file an annual Form 990 and a broader exemption from federal income tax, the next question is, "How do I get this magical exclusion?"

### How to qualify for Section 115 status

As discussed above, to be eligible for the Section 115 exclusion, an organization is not itself required to be a state or political subdivision. Also, there is no requirement that an organization be tax exempt under Section 501(c) to qualify for the Section 115 exclusion. Thus, a taxable entity may qualify for the Section 115 exclusion and, to this end, the author's firm has worked with several exempt organizations that have obtained Section 115 recognition for their taxable subsidiaries to mitigate the tax impact of the organizations' activities.<sup>39</sup>

In addition to being a permissible exclusion for both tax-exempt and taxable entities, it is easy to obtain the Section 115 exclusion. Generally, there is no requirement that organizations obtain any ruling from or file any application with the Service prior to taking advantage of the Section 115 exclusion. Thus, the process, similar to obtaining tax exempt status under Section 501(c)(4), for example, simply requires an organization to self-certify that it satisfies

the requirements of Section 115. However, it is generally advisable that tax-exempt organizations obtain a private letter ruling regarding the characterization of their income as excluded pursuant to Section 115. As discussed above, to be exempt from the annual Form 990 filing requirements, an organization must first obtain a letter ruling regarding its qualification for the Section 115 exclusion. Also, as a practical matter, it would be prudent for an existing organization that has reported substantial amounts of income on prior Forms 990 to request a letter ruling regarding the character of its income under Section 115. In the absence of such a re-

quest, the drastic change in the organization's reported earnings would likely raise suspicions within the Service and may prompt an examination, which would likely entail more risk and expense than a ruling request.

### **Conclusion**

For organizations that qualify for the exclusion from gross income, Section 115(1) can offer many substantial benefits. Thus, organizations and practitioners should consider whether they are in a position to take advantage of this seldom-used Code section. ■