

HJR

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Conditional repeal of subsection (d). — Under § 28, ch. 134, SLA 1992, subsection (d) "is repealed on the day that the revisor of statutes certifies to the legislature that the Alaska Supreme Court has made a final determination that, in the absence of AS 43.23.045(e), repealed by sec. 29 of this Act, or AS 37.13.145(d), added by sec. 19 of this Act, no judge or juror is disqualified from serving as a judge or juror

solely because the judge or juror may qualify to receive a permanent fund dividend."

Cross references. — For transfer of certain income earned by the Alaska permanent fund prior to July 1, 1982, to the undistributed income account, see § 15, ch. 81, SLA 1982.

Effect of amendments. — The 1992 amendment, effective July 1, 1992, rewrote this section.

NOTES TO DECISIONS

Stated in *State, Dep't of Revenue v. Cosio*, 858 P.2d 621 (Alaska 1993); *Exxon Corp. v. Heinze*, 32 F.3d 1399 (9th Cir. 1994).

Sec. 37.13.150. Corporation budget. The revenue generated by the fund's investments must be identified as the source of the operating budget of the corporation in the state's operating budget under AS 37.07 (Executive Budget Act). The unexpended balance of the corporation's annual operating budget does not lapse at the end of the fiscal year but shall be treated as income under AS 37.13.140. (§ 5 ch 18 SLA 1980; am § 10 ch 81 SLA 1982; am § 20 ch 134 SLA 1992)

Effect of amendments. — The 1992 amendment, effective July 1, 1992, substituted "fund's investments" for "corporation's investments."

Sec. 37.13.160. Audits. The Legislative Budget and Audit Committee may provide for an annual post audit and annual operational and performance evaluations of the fund's investments and investment programs. (§ 5 ch 18 SLA 1980; am § 11 ch 81 SLA 1982; am § 21 ch 134 SLA 1992)

Cross references. — For the responsibilities of the Legislative Budget and Audit Committee, see AS 24.20.206.

Effect of amendments. — The 1992 amendment, effective July 1, 1992, substituted "funds investments" for "corporation's investments."

Sec. 37.13.170. Reports and publications. By September 30 of each year, the board shall publish a report of the fund for distribution to the governor and the public. The board shall notify the legislature that the report is available. The report shall be written in easily understandable language. The report must include financial statements audited by independent outside auditors, a statement of the amount of money received by the fund from each investment during the period covered, a statement of investments of the fund including an appraisal at market value, a description of fund investment activity during the period covered by the report, a comparison of the fund performance with the intended goals contained in AS 37.13.020, an examination of the effect of the investment criteria of this chapter on the fund portfolio with recommendations of any needed changes, and any other information the board believes would be of interest to the governor, the legislature, and the public. The annual income statement and balance sheet of the fund shall be published in at least one newspaper in each judicial district. The income statement and balance sheet for the two fiscal years preceding the publication of the election pamphlet under AS 15.58 shall be included in that pamphlet. (§ 5 ch 18 SLA 1980; am § 22 ch 134 SLA 1992; am § 62 ch 21 SLA 1995)

Effect of amendments. — The 1992 amendment, effective July 1, 1992, substituted "fund" for "corporation" throughout the section.

The 1995 amendment, effective August 8, 1995,

deleted ", legislature," following "governor" in the first sentence, added the present second sentence, and substituted "impact" for "effect" in the fourth sentence.

Sec. 37.13.180. Tax exemption. The corporation and the fund are exempt from all taxes and assessments in the state. All security instruments issued by the corporation or

side of the United States" for "in a foreign country" and "capital, surplus, and retained earnings" for "capital and surplus" in paragraph (15), and added paragraphs (21) and (22); in subsection (h), inserted "or for the sale of nondomestic currencies" and substituted "investments" for "securities"; and in subsection (i), deleted the former first sentence, which was similar to the present last sentence, and added the present last sentence.

The 1992 amendment, effective July 1, 1992, rewrote this section.

The 1994 amendment, effective May 25, 1994, in paragraph (g)(16), inserted "the total value held by the fund in each investment does not exceed \$150,000,000, and, if the total value held by the fund

in each investment exceeds \$150,000,000," and made a related stylistic change in the introductory language, substituted "33 percent" for "60 percent" in subparagraphs (A) and (B), and substituted "67 percent" for "40 percent" in item (B)(i).

The 1996 amendment, effective June 26, 1996, substituted "investment grade" for "A or better" in paragraphs (g)(7) and (g)(19), rewrote paragraph (i)(4), repealed paragraph (i)(5), and added subsection (o).

Legislative history reports. — For Senate letter of intent related to the 1989 amendments to this section by ch. 4, SLA 1989 (CSHB 69(SA)), see 1989 Senate Journal 621.

Sec. 37.13.130. Gains and losses. [Repealed, § 13 ch 81 SLA 1982.]

Sec. 37.13.140. Income. Net income of the fund includes income of the earnings reserve account established under AS 37.13.145. Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses. Income available for distribution equals 21 percent of the net income of the fund for the last five fiscal years, including the fiscal year just ended, but may not exceed net income of the fund for the fiscal year just ended plus the balance in the earnings reserve account described in AS 37.13.145. (§ 5 ch 18 SLA 1980; am § 8 ch 81 SLA 1982; am § 1 ch 28 SLA 1986; am § 18 ch 134 SLA 1992)

Effect of amendments. — The 1992 amendment, effective July 1, 1992, inserted near the beginning "fund includes income of the earnings reserve account

established under AS 37.13.145. Net income of the" and substituted "fund" for "corporation" in three places.

Sec. 37.13.145. Disposition of income. (a) The earnings reserve account is established as a separate account in the fund. Income from the fund shall be deposited by the corporation into the account as soon as it is received. Money in the account shall be invested in investments authorized under AS 37.13.120.

(b) At the end of each fiscal year, the corporation shall transfer from the earnings reserve account to the dividend fund established under AS 43.22.045, 50 percent of the income available for distribution under AS 37.13.140.

(c) After the transfer under (b) of this section, the corporation shall transfer from the earnings reserve account to the principal of the fund an amount sufficient to offset the effect of inflation on principal of the fund during that fiscal year. The corporation shall calculate the amount to transfer to the principal under this subsection by

(1) computing the average of the monthly United States Consumer Price Index for all urban consumers for each of the two previous calendar years;

(2) computing the percentage change between the first and second calendar year average; and

(3) applying that rate to the value of the principal of the fund on the last day of the fiscal year just ended.

(d) Notwithstanding (b) of this section, income earned on money awarded in or received as a result of *State v. Amerada Hess, et al.*, 1JU-77-847 Civ. (Superior Court, First Judicial District), including settlement, summary judgment, or adjustment to a royalty-in-kind contract that is tied to the outcome of this case, or interest earned on the money, or on the earnings of the money shall be treated in the same manner as other income of the Alaska permanent fund, except that it is not available for distribution to the dividend fund, and shall be annually deposited into the principal of the Alaska permanent fund. (§ 9 ch 81 SLA 1982; am § 2 ch 28 SLA 1986; am § 19 ch 134 SLA 1992)

To: House Judiciary

April 13, 2000

I voted No last September. I am opposed to HJR49.

HJR49 is a poor idea from a policy perspective because it takes away the Legislature's authority to appropriate funds.

HJR49 is a poor idea from a financial perspective for all the reasons that changing to a percentage of market value distribution is a better idea. Although there are no performance guarantees with the market value approach, it does remove the dependence on volatile realized earnings and offers a more stable dividend distribution based on the real return of the Permanent Fund investments.

However, the most important consideration of HJR49 is a philosophical one: whether decreasing our Permanent Fund dividend should be an option to help bridge our growing fiscal gap. I support a healthy dividend distribution. I think a long range fiscal plan including better control of government spending and a combination of reasonable taxes should be developed before the dividend program or the fund's undistributed income is tapped. However, adjusting the dividend should remain a legislative option for balancing personal benefit and the common good for all Alaskans as other General Fund revenue sources are depleted. Shortchanging funding for essential public services or raising exorbitant taxes in order to sustain a large personal dividend does not serve our best interests or the purposes for which the Permanent Fund was established.

Many people who support HJR49 believe it will preserve the value of their dividend. There are no guarantees for a continued high dividend, no matter what formula is applied. Other people want the government to keep its hands off the dividend program, no matter how much essential public services must be cut. I hope that with continued discussion the public will come to understand the real fiscal picture and agree to a well-reasoned long-term financial plan that controls spending, taps additional sources of revenue including a combination of taxes, and then uses Permanent Fund earnings to balance personal and common good for the benefit of all Alaskans.

Thank you.

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April 7, 1998

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By Overnight Delivery

Mr. James L. Baldwin
Assistant Attorney General
Alaska Department of Law
Civil Division
P.O. Box 110300
Juneau, AK 99811-0300

Re: Alaska Permanent fund Corporation

Dear Jim:

You have requested an update of the Report ("Report") that we provided to the Alaska Permanent Fund Corporation ("APFC") approximately 10 years ago, regarding the question whether the Fund and APFC are subject to federal taxation. I have reviewed the cases and rulings that have been issued since 1988, as well as the statutory amendments made to Title 37, chapter 13 of the Alaska Statutes, Attorney General opinions, and the recent annual reports. This letter summarizes and discusses the legal developments relating to the central legal arguments addressed in our previous report. We assume for purposes of this letter that the factual description of the Alaska Permanent Fund ("Fund") and the APFC contained in the Report are still applicable, apart from the legislative amendments which substituted references to the fund for references to the APFC, and other changes discussed below at page 32.

I. Executive Summary

As before, we believe that there are three primary arguments supporting the position that the income of the Fund and the APFC are not subject to federal taxation.

First, it might be argued that the constitutional doctrine of implied immunity of state instrumentalities from federal taxation applies. As we concluded before, this doctrine has been so narrowly construed that it offers only questionable protection. The few legal developments under this doctrine have only reinforced our previous conclusion.

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Second, we relied on a history of IRS rulings, albeit without judicial authority, to argue that income earned by a State or an integral part of a State is not specifically subjected to State taxation. Since 1988, there has been quite a lot of ruling activity related to the integral part doctrine, as well as publication of the first judicial decisions to address it. We believe that these additional authorities strengthen the position that the Fund and the APFC are an integral part of the state and thus not subject to state taxation.

Third, we argued that, in the alternative, the income is excluded under section 115 of the Internal Revenue Code ("Code").¹ Section 115 excludes from gross income any income that is derived from the conduct of an essential governmental function and accrues to a State or political subdivision. At the time of the Report, there were a number of older authorities in this area, but there were no recent authorities. Since 1988, this has been an unusually active area for IRS rulings. Recent case law also has addressed this statute, and the IRS has published one ruling of precedential value. Although we believe that these developments continue to support also the position we took with respect to the Fund and the APFC, they do indicate that the IRS's analysis increasingly turns on the issue of private benefit.

In short, we believe that the legal developments in this area in the last 10 years reinforce the conclusions reached in our earlier Report.²

Finally, we note that a number of the recommendations we made to strengthen the Fund and the APFC's position were subsequently adopted. We felt at the time that the practical changes and proposed statutory amendments would substantially reinforce the State's legal position that the Fund and the APFC are integral parts of the State and that income earned on Fund assets is earned directly by the State. We believe that the factual analysis in the subsequent cases and rulings underscore the wisdom of such actions.

¹ All references to the Internal Revenue Code or the Code are to the Internal Revenue Code of 1986 as amended, 26 U.S.C. §1 *et seq*

² We have reason to believe that the IRS is currently considering several additional private rulings under the integral part doctrine and section 115, which may further elaborate on the factors that are essential to exemption under the integral part doctrine or exclusion from income under section 115. We understand that they have been controversial, in that they were previously submitted and rejected and have been resubmitted to the IRS. We do not have enough information at this time to determine if the rulings will add any meaningful discussion or elaboration to the prior rulings.

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II. Constitutional Immunity

The 1988 Report concluded that the constitutional doctrine of implied intergovernmental tax immunity had been so narrowly interpreted over the years that it was unlikely to provide a reliable basis for arguing that any income received by a state was immune from federal taxation should Congress choose to impose such taxation. At one time, the constitutional doctrine of intergovernmental tax immunity held that, as a matter of constitutional relationship between the federal government and the states, the federal government may not tax the sovereign states. This doctrine has been so eroded over the years that it is difficult to determine what its remaining scope might be.

During our previous consideration of this issue, the Supreme Court decided *South Carolina v. Baker*, 485 U.S. 505 (1988), which held (among other rulings) that the doctrine of intergovernmental immunity did not bar a nondiscriminatory federal tax on interest earned by holders of state government-issued bonds ("[T]he States have never enjoyed immunity from all federal taxes considered to be 'on' a State."). Although that case did not deal with a federal attempt to tax a state or state instrumentality, but rather a state attempt to deal with a tax on bondholders, the Court offered a sweeping analysis of the doctrine of intergovernmental tax immunity, a discussion which might be characterized as dicta. Although the Court never addressed the question of the "extent to which, if any, States are currently immune from direct federal taxation," 485 U.S. at 523 n. 14, the decision includes the often-quoted caveats that "at least some state activities have always been subject to direct federal taxation", 485 U.S. at 523 n.14, and "at least some nondiscriminatory federal taxes can be collected directly from the States even though a parallel state tax could not be collected directly from the Federal Government." 485 U.S. at 523.³

We concluded that *South Carolina*, read in conjunction with the Court's expansive reading of the commerce clause in *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), suggested that the Court recognized few restraints on the federal commerce or taxing powers over state activities. Nevertheless, we believed that the Court was likely to conclude that there was a limited set of core powers of sovereignty that would remain immune from the federal taxing power, such as state tax revenues, but that there was less comfort that the Court would not approve a

³ The Court defined "directly" with respect to a state tax on the federal government as "when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the government that the two cannot realistically be viewed as separate entities ..." and indicated that the same definition applied to a federal tax on a state. 485 U.S. at 523.

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nondiscriminatory tax on other state income, such as investment income. Report at 69-76.

The South Carolina case, of course, had just been decided at the time of our prior Report, and the impact of the decision and dicta therein had not yet been determined. Since then, there have been approximately half a dozen federal cases regarding the intergovernmental tax immunity doctrine, and none have given us a reason to alter this conclusion.

Specifically, in a case concerning federal taxation of investment income of the state-created Michigan Educational Trust ("MET"), a federal district court rejected the intergovernmental tax immunity claim on the grounds that the MET was not so closely connected to the state that the two could be realistically be viewed as separate entities. Michigan v. United States, 802 F. Supp. 120, 126 (W.D. Mich. 1992). On appeal, the state dropped its intergovernmental immunities claim. The 6th Circuit eventually ruled that the Michigan Educational Trust was indeed an "integral part" of the state, and thus exempt from federal taxation. Michigan v. United States, 40 F. 3d 817 (6th Cir. 1994). The Court noted, however, that "it was an appropriate move" for the state to drop its intergovernmental immunities challenge because that doctrine had "been severely eroded with the passage of time, and several years ago the Supreme Court suggested that it is now an open question whether there is 'any' extent 'to which States are currently immune from direct non-discriminatory federal taxation.'" Michigan v. United States, 40 F.3d at 823 (quoting South Carolina v. Baker, 485 U.S. 505, 518 n.11 (1988)).

The 6th Circuit concluded that "we are confident that today's Supreme Court would say that Congress is free to impose a non-discriminatory tax on the investment income at issue here if it wants to."

40 F.3d at 823 (emphasis added). Since the Court had already concluded that the MET was an integral part of the state, this statement with respect to the intergovernmental immunities doctrine is disturbing, since it indicates that even a generally favorable Court would not conclude that a state's investment income is exempt from federal taxation.

Since then, no other case has addressed the question of the potential permissible constitutional scope of federal taxation of the states.⁴

⁴ Several cases have discussed the doctrine in the context of discriminatory indirect state taxation of persons or entities arguably associated with the federal government. These include: discriminatory state taxation of federal retirees, *see. e.g., Harper v. Virginia*, 509 U.S. 86 (1992); Davis v. Michigan, 489 U.S. 803 (1989); nondiscriminatory state taxation of oil and

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III. Federal Taxation Does Not Reach Income Earned by an Integral Part of a State

We previously contended that the strongest argument was that the Fund and the APFC were an "integral part" of the state, and thus wholly outside the federal tax code. That is, the IRS has consistently taken the position that the federal income tax law does not impose income tax on income earned directly by a State or an entity that is an "integral part" of a State absent a specific statutory provision.

This is a separate argument from the constitutional doctrine of intergovernmental immunities, which is premised on the constitutional relationship between the federal government and the states.

In contrast, the "integral part" argument assumes that, if Congress so chose, it might be empowered to tax the states directly, but that careful review of the income tax laws reveals that Congress has not attempted to do so. At its most developed, the "integral part" theory argues that any congressional imposition of tax must be clear and unequivocal. The Internal Revenue Code expressly taxes corporations, but does not expressly tax states or political subdivisions, and there is no evidence that Congress ever intended the code to apply to states. The IRS had developed this theory in several precedential published rulings as well as numerous nonprecedential administrative interpretations and internal memoranda. See Report, at 27-39.⁵

gas production on Indian reservations by non-Indian lessees, *Cotton Petroleum Corp. v. New Mexico*, 490 U.S. 163 (1988) (describing the intergovernmental immunities doctrine as "thoroughly repudiated" by modern case law"); and whether state use taxes on bankruptcy sale proceeds unduly burden the processes of the federal bankruptcy court, *California v. Sierra Summit, Inc.*, 490 U.S. 844 (1989).

⁵ See the Report, at footnotes 26 and 30, for a discussion of the varying forms of IRS interpretations and rulings, and their precedential weight. In this letter, we have included discussion of many Private Letter Rulings (PLR) which are written advice provided to taxpayers who submit written requests for rulings on specific legal issues based upon a specific set of facts. Under section 6110(j)(3), such private letter rulings are directed only at the taxpayer that requested the ruling and may not be used or cited as precedent. Since the IRS has substantially reduced its output of published guidance and no longer produces even general counsel memoranda (discussed at footnote 30 of the report), private rulings are a valuable window into the developing position of the IRS, particularly in areas such as this which are rarely the subject of published guidance and even more rarely litigated. Although nonprecedential, private letter rulings also can provide a basis for seeking a similar interpretation by the IRS with respect to similar fact patterns.

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At the time of the Report, there was no judicial authority to support the "integral part" theory. In our Report, we discussed the then-recent IRS private ruling issued to the Michigan Educational Trust ("MET"), which was the nation's first government-sponsored prepaid college tuition plan. In that ruling, the IRS determined that the fund was not an integral part of the state, and thus its income was not exempt from taxation. PLR 8825027. (March 29, 1988). Since our Report, the State of Michigan challenged the IRS in tax refund litigation. The trial and appellate decisions in Michigan v. United States are the only judicial decisions ever to consider the integral part theory. 802 F. Supp. 120 (W.D. Mich. 1992), *rev'd*, 40 F.3d 817 (6th Cir. 1994).

Since 1988, the IRS has been invited to rule on the "integral part" theory several times, due in large part to the interest on the part of the states in prepaid college tuition investment programs, disaster insurance funds, and self-insurance programs for local governments. The IRS has issued another precedential Revenue Ruling as well as numerous private rulings. These rulings, however, have further developed the theory in unexpected ways. The IRS has been inexplicably inconsistent in its approach, narrowly applying the theory in some cases (prepaid state tuition plans) yet expansively applying it in others (state disaster insurance programs).

A. Michigan Educational Trust

The Michigan Education Trust case is interesting because of the many structural parallels with APFC in terms of its creation and control by the State. Its facts diverge, however, in terms of the source and destination of the funds. It further highlights the IRS's concern with private benefit, although this typically is raised in the context of section 115 rather than the "integral part" doctrine.

The Michigan Education Trust was established as a public corporation. Its corporate purpose — higher education — was declared by the legislature to be a public purpose and an essential function of state government. It was "allocated by law" to the state treasury department, but acted independently of the department. It had an independent board appointed by the governor and confirmed by the senate; the board included the state treasurer. The board exercised its powers as authorized by the statute, including investing, paying out funds, determining the eligibility of participants, and contracting on behalf of the state. A separate state administrative board was made up of officers of the state, including the governor. The administrative board had to approve the form contracts used.

The state attorney general had advised the trust's board that it was an "agency" of the state. The employees of MET were subject to rules governing state employees, e.g., civil service and state laws governing liability of public officers, and the MET was

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subject to laws governing the conduct of state agencies, e.g., open records law, open meetings laws, and FOIA. The attorney general provided legal counsel.

An important factor was the source of funds — the entire assets of the MET consisted of actuarially-determined amounts paid by parents under pre-paid tuition contracts. MET was to invest the funds and guaranteed the college tuition of beneficiaries at some time in the future. The act expressly provided that the funds were to be used solely for the purposes of the trust and could not be used by the state for any other purposes. The assets of MET were not considered state money or state revenues, and were not subject to payment of full faith and credit obligations of the state (although the appellate court later determined that the reason for this may have been to give the trust broader investment powers than it otherwise would have). Another important factor was the destination of funds, which were to be paid out to beneficiaries. Moreover, upon dissolution, the assets would not go to the state but would be distributed pro rata to the investors, although state could claim any actuarially determined excess. The state was not legally obligated to make up any shortfall in funding, although it was authorized to do so.

The MET funds were segregated from state funds, although they could be pooled with state funds for investment purposes. Apparently, state treasury department employees actually handled the investments. The bank trust accounts were in the name of the state treasurer, with the state as agent for the trust. MET made an annual accounting to the state governor and legislature. Annual audits were conducted by the state auditor general. Fund payments were paid out through state warrants. Trust income was exempted from state taxes.

During our work on the 1988 Report, the IRS issued a private letter ruling rejecting the exempt status of the MET. PLR 8825027 (March 29, 1988). The IRS discussed the "integral part" theory only briefly, concluding that MET was not an integral part of the state. The key factors mentioned in the IRS ruling were that it was created as a corporation to operate independently from the state; the trustees' decisions could not be overridden by any state agency; the funds were not derived from the state, were not subject to the claims of the state's creditors, and were not considered state funds; the state could not loan, transfer, or use MET funds for any purpose; and the MET funds could be used only for the tuition payment or refunds to investors.

Michigan then filed returns and sued for a refund of the taxes paid. In the District Court, the parties stipulated the facts and filed cross motions for summary judgement. The District Court denied the refund claim, determining as a matter of law that the MET was subject to federal taxation. *Michigan v. United States*, 802 F. Supp. 120 (W.D. Mich. 1992). Michigan raised, and the court addressed, several possible

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bases for exemption —constitutional doctrine of intergovernmental immunities and the 10th Amendment, the integral part of the state doctrine, section 115, and section 501(which expressly exempts charities and certain other similar entities).

The District Court implicitly accepted the "integral part" theory as a matter of law that states are *de facto* exempt from federal internal revenue laws. MET was a corporation, however, and thus was subject to federal taxation unless it was an integral part of the state entitled to the state's immunity. The Court concluded that MET was not an integral part of the state because, although the state put up some seed money, the actual funds came from investors and could not be used by the state to pay state creditors or for any other purposes. Also, MET's obligations were not backed by the full faith and credit of the state.⁶ The Court concluded that these facts demonstrated that MET was an entity distinct from the state and not entitled to immunity as an integral part of the state.

Michigan appealed to the 6th Circuit, which reversed, holding that the MET was exempt from federal taxation, as an instrumentality or political subdivision, and as an integral part of the state. *Michigan v. United States*, 40 F. 3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W. D. Mich. 1992). The 6th Circuit initially addressed the question whether Congress had imposed taxation on a government corporation such as MET. The Court observed that the Internal Revenue Code plainly imposes tax on corporations. Literally read, that section would tax all governmental corporations include municipalities organized as bodies corporate, public universities, and federal instrumentalities that are organized in corporate form (citing a list of federally owned corporations that are presumed to be exempt from taxation). The IRS conceded the legal premise that the Code did not impose taxation on a state, a political subdivision, or an "integral part of a state." 40 F.3d at 823.

The Court further cited a long line of Supreme Court authorities requiring Congress to express its intent unequivocally when it intends to alter the usual constitutional balance between the States and the federal government. The Court concluded that Congress knew how to make the kind of "plain statement" necessary to impose a tax on a state instrumentality but had not done so here.

⁶ The Court's opinion regarding the constitutional arguments and section 115 are discussed at pages 3-4 and 25-32, respectively. The court also rejected exemption under section 501 because MET's direct benefits impermissibly inured only to parents who purchased contracts, thus violating the private benefit and private inurement restrictions on section 501 charitable organizations. As we suggested in our prior Report, a similar concern would likely be raised with respect to the Fund, APFC, and the dividend program if exemption were sought under section 501.

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of the subdivision were for a public purpose. Responding to the District Court's rather summary dismissal of higher education as a governmental function, the 6th Circuit determined that education was a governmental purpose and public function, particularly given the history of Michigan as a land grant state and the emphasis in the state constitution of education as an essential government function. The Court noted that the act creating the trust included extensive legislative findings that it was an essential function of the state to support education, to encourage attendance to state institutions, and to provide educational assistance to students. The Court found that education was at least as much a state purpose as the bridges and tunnels that were the functions of the entities held to be exempt political subdivisions in the prior case law. The Court thus concluded that MET was a public agency authorized to exercise contracting powers on behalf of the state for a purpose declared by the legislature to be a public purpose.

The Court then added that MET would qualify as a political subdivision since it was a "public body corporate and politic", and thus was "in a broad sense" a municipal corporation. *Id.* at 825-26.⁹

For further support, the Court also borrowed a six-factor test used by the IRS and the courts for determining whether an entity is an agency or instrumentality for purposes of federal law governing governmental benefits plans. Those factors are (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether it performs its function on behalf of a state or political subdivision; (3) whether there are private interests involved or whether the state or political subdivision has the powers and interests of an owner; (4) whether control and supervision is vested in public authorities; (5) whether express statutory authority is required for the instrumentality and whether such authority exists; and (6) the degree of financial autonomy and the source of operating expenses. 40 F.3d at 826-27 (citing *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910 (2d Cir. 1987), *cert. denied*, 485 U.S. 936 (1988), and Rev. Rul. 57-128, 1957-1 C.B. 311). The Court concluded that MET satisfied the first five factors (the sixth was not presently satisfied but the court

subdivision cases discussed by the 6th Circuit include *Commissioner v. White's Estate*, 144 F.2d 792 (2d Cir. 1944) (bridge authority was political subdivision with power to issue exempt bonds); *Philadelphia National Bank v. United States*, 666 F.2d 834 (3rd Cir. 1981) (Temple University was not a political subdivision eligible to issue tax-exempt debt); *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910 (2d Cir. 1987), *cert. denied*, 485 U.S. 936 (1988) (metropolitan transit authority (MTA) was political subdivision and pension plan was part of MTA).

⁹ The Court did not cite any authority for this conclusion, which not surprisingly, also has been criticized by commentators and the IRS.

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speculated that it could not be ruled out for the future), and concluded that, on balance, the presence of five factors led to the conclusion that it was a state instrumentality.¹⁰

The Court also distinguished *United States v. Maryland Savings-Share Insurance Corporation*, 308 F.Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970) ("*MSSIC*"), which was discussed in our Report at pages 85-90. In *MSSIC*, the Supreme Court upheld the lower court's conclusion that a nonprofit insurance corporation chartered to insure savings and loan accounts was not exempt from federal taxation as an instrumentality. The 6th Circuit pointed out that that *MSSIC* was a private corporation, organized by and for savings and loan members, with a Board largely comprised of elected directors. 40 F.3d at 827-828. In contrast, the MET was a public instrumentality, had a board appointed by the governor, and was delegated authority to contract on behalf of the state.

The court also rejected both of the government's arguments that the trust could not be an integral part of the state because its corporate form made it functionally independent and because the source and earmarking of funds made it fiscally independent. The Court determined that it was "immaterial" that the state chose to use a public corporation rather than to assign the functions to a traditional department. 40 F.3d at 828. The Court cited the example of the U.S. Postal Service as a corporate entity that did not become taxable by virtue of its corporate form. 40 F.3d at 828-29. Similarly, the Court rejected the argument that the source or earmarking of funds was determinative, again citing the example of the U.S. Postal Service, the TVA, and ports authority as examples of governmental instrumentalities that obtain funding from private sources and are earmarked for the performance of public functions that the agencies were created to perform. The Court was also critical of the government's focus

¹⁰ Critics argue that this six-factor test of "instrumentality" is irrelevant for two reasons. First, it was developed in a different context involving different law, legislative history and intent, and different requirements (ERISA and governmental plans). This argument was made by the IRS in criticizing the *MET* case in subsequent rulings. See, e.g., PLR 9809013 (Nov. 7, 1997); PLR 9706006 (Nov. 8, 1996); PLR 9627016 (April 5, 1996); PLR 9622019 (Feb. 28, 1996). The IRS's challenge is a bit disingenuous, however, since it was the IRS itself that issued a series of G.C.M.s and rulings relying on this six-factor test for purpose of section 115. See, e.g., G.C.M. 34704 (Dec. 2, 1972); G.C.M. 34502 (May 2, 1971); PLR 8820030 (Feb. 16, 1988); PLR 8740015 (July 2, 1987); PLR 8650017 (Sept. 10, 1986). Second, critics argue that "instrumentality" is not synonymous with "political subdivision" or "integral part of a state", and that instrumentalities are not even certain of exemption under section 115. See, e.g., Letter to Editor from Prof. Ellen P. April, 66 Tax Notes 121 (Jan. 2, 1995) (citing *Maryland Savings-Share Insurance Corp. v. United States*, 400 U.S. 4, 7 n.2 (1970) ("*MSSIC*") and Rev. Rul. 77-261, 1977-2 C.B. 34).

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on the form, rather than the substance of the entity, analogizing the trust to government student loan programs and state pension funds. *Id.* at 829.

Not surprisingly, the IRS has chosen to reject the 6th Circuit's decision, criticizing it in public appearances and statements, and taking the position that it is not authoritative anywhere outside the 6th Circuit. In rulings since *MET*, the IRS has repeatedly rejected the analysis of the Court as "internally inconsistent", arguing that its "reliance on the [six] factors listed in Rev. Rul. 67-128 ... to reach its conclusion is misplaced." *See, e.g.*, PLR 9809013 (Nov. 7, 1997); PLR 9706006 (Nov. 8, 1996); PLR 9627016 (April 5, 1996); PLR 9622019 (Feb. 28, 1996). Moreover, the IRS declared that it would no longer entertain state requests for rulings relating to the exemption of state prepaid tuition programs under the "integral part" theory or section 115, thus shutting the door on states that might want to adopt a variation on the Michigan plan that might be more acceptable to the IRS. Rev. Proc. 96-34, 96-1 C.B. 771.

Lacking access to guidance, the states began to lobby for Congressional grant of exemption to such programs. Finally, in 1996, the Small Business Job Protection Act added new section 529 to the Code, which expressly provides tax-exempt status for state tuition programs that meet the requirements of the statute. P.L. 104-188, §1806. Even after this statement of Congressional approval, the IRS continues to refuse to issue rulings under the "integral part" theory or section 115 to states relating to prepaid tuition programs, thus in effect taking the position that only plans organized pursuant to the statute may be exempt. Rev. Proc. 98-3, 1998-1 I.R.B. 100 (Jan. 5, 1998).

B. Disaster Insurance Programs

The IRS has issued a number of widely publicized "integral part" rulings to states in recent years that shed additional light on the IRS's concerns in this area, particularly regarding which characteristics of an entity qualify it as an integral part of the state. In contrast to the *MET* IRS ruling, the extent to which a proposed state entity's activities appear to be private rather than public in nature (*e.g.*, private funds, investors, beneficiaries) continues to be a significant consideration, yet apparently is not determinative once certain other indicia of state creation and control and financial commitment are satisfied.

The most significant rulings in recent years involve a series of proposed state disaster insurance programs, which typically create some sort of entity or fund which individuals or insurers would pay into or purchase insurance from, which entity would then pay claims or reimburse insurers in the event of a certain natural disaster.

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1. Florida Hurricane Catastrophe Fund

In 1995, Florida successfully obtained a private ruling which held that the Hurricane Catastrophe Fund ("CAT Fund"), a trust fund created by state law, would be considered an integral part of the state. PLR 9507037 (Nov. 4, 1994). It is described as a "trust fund under state law", i.e., a separate legal entity, but it does not appear from the ruling or the state statute that it was structured as an actual trust but rather as a state fund. Participating insurers were to pay premiums into the fund, and would be reimbursed for a percentage of losses resulting from certain events. The state also imposed an assessment on a broader class of insurers, including many nonparticipants, with the revenues to be earmarked for the fund.

It appears that the state was not liable if the fund proved to be insufficient, although if that occurred, local governments could issue revenue bonds for the benefit of the fund, and the bonds would be backed by the fund's future revenues. It appears that monies in the fund were not subject to the state's creditors. The ruling does not indicate whether the fund was treated as a state account for accounting purposes, or whether there was any duty to provide financial reports or to be audited by the state. The state legislature also could appropriate funds from the fund for grants to local governments and nonprofits for preparedness programs. All assets of the fund would revert to the state upon termination of the fund. It was governed by the State Board of Administration, a three-member board comprised entirely of state officials. Operations of the fund were conducted by fund employees and contract advisors. It appears that the board was not created for the purposes of governing the fund, but rather was a pre-existing body that had been created under the state constitution to administer certain special purpose tax revenues, and also could be delegated other powers under state law.

The ruling cryptically states that "[t]he method of accounting for moneys related to certain operations does not by itself determine whether the operation is an integral part of the state or an entity separate from the state." Nothing in the ruling discusses the method of accounting for funds. It is known that the fund was very controversial and was initially rejected by the IRS. This comment may be an observation that the fund was actually a state fund, rather than an independent fund, and that that distinction alone did not resolve the issue of integral part. Certainly, past IRS rulings have found that the existence of a separate legal entity or independent entity was a determinative factor in finding that an entity was not an integral part of the state.

The ruling does rely on the state's exercise of its taxing power and "significant contribution" of monies to the fund, the state's power to appropriate monies from the fund for certain specified purposes, and the state's receipt of the assets upon dissolution as significant factors in concluding that the state has a "financial interest" in the fund. Another factor cited by the ruling was that the monies could only be used for purposes

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authorized by state law, and no other purposes. The ruling also noted that the state exercised direct control over the fund through the board which consisted of state officials.

Curiously, there was no discussion of the issue which animated the debate over the MET ruling — the significant private benefit. Here the very purpose of the fund, as there, was to pay out virtually all of the income and assets to private parties, but that issue was not even discussed. Apart from the MET ruling, it would appear from a general review of IRS rulings that the private benefit analysis is limited to section 115 and plays little or no part in determining whether an entity is an integral part of a state. That may well be the wrong interpretation of the IRS's position, however. Contemporaneous public statements by Florida state officials during the ruling negotiations indicate that the IRS's chief concern was indeed the MET -type private benefit issue. The Florida CAT Fund was perceived by the IRS not as a state fund but rather as plan to help private insurers. Negotiations with the IRS dragged on for over a year — the IRS apparently demanded that the state have a significant investment of its own funds at risk in the fund before it would rule that it was an integral part of the state.

Subsequently, Florida apparently did not enact the plan in the form it was presented to the IRS, and the IRS threatened to withdraw the exemption ruling unless the state committed "significant" state funds to the fund. Several amendments to the plan were made, including additional annual appropriations from the general revenue fund and another state trust fund for the first two years, a broader base of nonparticipants who would be taxed to fund the program, and additional powers on the part of the state to appropriate monies from the fund. The IRS accepted these changes and issued a favorable supplemental ruling. PLR 9522039 (March 6, 1995).

2. Hawaii Hurricane Relief Fund

In the wake of Hurricane Iniki, Hawaii also developed a state sponsored disaster relief fund, which the IRS held was an integral part of the state. PLR 9627016 (April 5, 1996). Significantly, the fund was established as a public corporation. The fund was placed under the State Department of Commerce and Consumer Affairs for administrative purposes. The board was made up of the commissioner of insurance, *ex officio*, and six members chosen by legislative leadership and the governor. Departmental employees were assigned to the fund, and continued to be considered state and departmental employees.

The fund issued hurricane policies for properties covered by private property insurance, and the private insurance companies served as servicing agents for the fund hurricane policy as well as the property insurance. The fund's policy revenues were

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representing the insurance industry and general public, to be appointed by the board members. Meetings of the board and advisory panel were subject to state open meetings requirements. The fund was administered under the direction of the state insurance commissioner. The initial plan of operations had to be approved by the commissioner and legislature. Subsequent amendments had to be approved by the commissioner. Senior executives would be employed under contract. The fund's employees were subject to state civil service requirements, and subject to state laws governing post-government employment.

The state annually would contribute the equivalent of the state premium tax collections on the fund policies to the fund as part of the fund's capital. The state also contributed the remaining balance in a defunct previous earthquake trust fund. Participating private insurers would pay an initial assessment to the fund based upon market share. The primary source of revenue, however, would be premiums for fund policies sold. The fund would purchase reinsurance. The statute authorized that a certain percentage of investment income could be used for earthquake mitigation programs. If the fund were unable to cover claims, the fund could ask the state treasurer to issue debt obligations to be repaid through a policy surcharge, but the state would have no liability for those obligations. The statute expressly provided that the state would not be responsible for any of the liabilities of the fund. In the event of the fund's termination, all assets would be transferred to the state.

The ruling distinguished MSSIC on the grounds that: (1) only three of eleven MSSIC directors were selected by state officials; (2) the state made no financial contribution to MSSIC; and (3) the state had no present interest in the income of MSSIC. The ruling also mentions that MSSIC was a corporation, but does not discuss the significance of that fact. The ruling also mentions that under the MSSIC charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Similarly, the California statute expressly declined to give the state's backing to the obligations or liabilities of the CEA.

The ruling also distinguished MET in a discussion, repeated in other rulings, that makes it clear that the IRS does not agree or acquiesce to that decision. The MET decision was distinguished as "internally inconsistent" because it found that the MET was both a political subdivision and an integral part of the state. The California ruling further rejected the decision's discussion of the factors listed in Rev. Rul. 57-128 as irrelevant because they apply only to entities that are separate from a state, and are not used to determine if it is a separate entity or an integral part of a state. This seems to misstate the Revenue Ruling, which admittedly is not an "integral part" or section 115 ruling, but in another context does spell out a list of factors to be considered in determining whether a entity is an instrumentality of a state or not.

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Other factors cited in the ruling were the significant government interest set forth by the state in providing assistance to its citizens and economy in the event of natural disasters of the magnitude of an earthquake. The state also had argued that this plan represented an exercise of the state's power to regulate an industry, and that the fund was as valid an exercise of state power as the regulatory alternatives.

Two months later, the IRS revoked the ruling letter for further review of the issue. Letter dated April 30, 1996, LEXIS, FEDTAX, TNT, 96 TNT 102-54. It appears that this revocation may have been prompted by the state legislature's consideration of further legislation that threatened to significantly revise the CEA.

The state then conducted an unusual high pressure campaign, seeking assistance from the White House and imposing pressure through its congressional delegation. Legislation was introduced in Congress to grant an express federal tax exemption to the CEA.

Then in June, 1996, the IRS reinstated the ruling granting exemption as an integral part of the state without discussion. PLR 9641010(June 25, 1996) (reinstating PLR 9622019). The ruling noted that the state legislature was considering legislation affecting the fund, and warned that the IRS was not giving any opinion as to the continuing exempt status of the fund if the legislation were to be enacted.¹¹

After the California legislature further amended the statutory scheme, the state again sought a reaffirmation of the IRS's ruling. Subsequently, the IRS again issued a ruling to California, concluding that after numerous statutory changes, the CEA was an integral part of the state. PLR 9706006(Nov. 8, 1996).

In general, the legislative amendments did not really address the issues of either state control or financial interest, which apparently were the chief concerns of the IRS. The chief purpose of the amendments appears to have been to forbid the CEA from declaring bankruptcy, to strengthen the capitalization of the fund, and to create additional "tiers" of remedy in the event that the assets of the fund proved inadequate to satisfy claims, including various additional surcharges on participating insurers. The

¹¹ Published accounts of the California Earthquake Authority tax negotiations, discussed below, and private discussions with Florida, Hawaii, and California state officials and IRS officials reveal that the IRS was very concerned about the overwhelmingly private benefit characteristics of these funds. The IRS required amendments, if necessary, to strengthen state control, to impose requirements that assets revert to the state upon dissolution (although given the nature of these funds, the possibility of remaining assets is so remote as to be meaningless), and most important, to require a significant state financial commitment.

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amendments also seemed to make it harder for participants to avoid sharing the burden of fund obligations by dropping out. The only amendments that seemed relevant enough to warrant mention in the IRS's discussion in the final ruling were: (1) the legislature "provided for" additional surcharges on policies, and probably more important, the state appropriated some monies to assist in the start-up of the fund, and loaned additional monies at a legal rate of interest; and (2) the board members and officers were made subject to the financial disclosure requirements for state officials. Otherwise, the ruling is almost verbatim identical to the earlier ruling (PLR 9622019).

The California ruling is somewhat surprising in that the state assumed no liability for the fund, unlike the Florida hurricane catastrophe fund. The California insurance commissioner publicly stated that lawmakers demanded that the state's general fund be immune from liability, and described the structure of the program as one of "building firewalls between the CEA and the General fund."

C. Other Integral Part Rulings

There have been a few other integral part rulings worth noting. Unfortunately, several rulings have made broad and disturbing statements that a corporation created by a state is not an integral part of a state because it is a corporation and is not within a branch of government. For example, in PLR 9549030 (Sept. 11, 1995), the IRS ruled that a corporation created by a county to manage a commercial district was not an integral part of the State or a political subdivision of the State "because it was created as an entity separate and distinct from the district and is not within the Executive or Legislative branches of County".¹²

Similarly, another ruling concerned a state-created public corporation which was organized to establish a university. PLR 8935012 (May 30, 1989). The governing board was appointed and confirmed by the state. It received state appropriations for capital outlays and operational expenses. Apparently the state itself argued that the corporation was an entity separate and apart from the state. The IRS concurred and concluded that it was not an integral part of the state, without further discussion.¹³

Similarly, the IRS has determined that a regional development authority was not an integral part of the state, apparently because it was formed as a separate corporation,

¹² The ruling did conclude that the corporation's income was excluded from taxation under section 115, and thus was required to file a federal corporate tax return.

¹³ The ruling did conclude that section 115 applied to exclude the corporation's income from federal taxation.

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had its own officers and employees, and was not under the control of any state agency or any one political subdivision. PLR 9009063 (Dec. 8, 1989).¹⁴

One distinction between these rulings and other favorable rulings is that these involve public corporations, while other favorable rulings involve trusts or other entities of more nebulous legal status. It is difficult, however, to determine the significance of corporate status, especially when the IRS does not elaborate on the issue, or when the IRS eventually finds the entity to be exempt under another provision. For example, while the IRS considered corporate status to be a negative factor for MET, it apparently was not the determinative factor in concluding that it was not an integral part of the state.

Certainly, there are other rulings that conclude that a corporation can be an integral part of the state. For example, the Hawaii hurricane fund was organized as a public corporation, yet the IRS did not raise that as an issue. It would appear generally that while corporate status is a significant factor for the IRS, it may be neutralized by sufficient evidence of state control and, in the words of the IRS, "domination." See, e.g., G.C.M. 39601 (Jan. 30, 1987) (lawyer trust fund); G.C.M. 38921 (Nov. 26, 1982) (housing authority).¹⁵ Yet it is extremely difficult to predict when separate organizational structure will be determinative or what level of government control renders a separately organized entity an integral part of the state.

Also, if a corporation cannot by definition qualify as an integral part of the state due to its separate legal existence, then the same rationale should apply to a trust. Yet there are several rulings that conclude that trusts can be integral parts of a state. See Rev. Rul. 87-2, 1987-2 I.R.B. 4 (1987).

In one recent ruling, the IRS held that a trust was an integral part of the state regardless of the fact that it was created as a separate and distinct entity apart from the political subdivision. The IRS reviewed a trust set up by a municipality to pay retiree medical benefits. PLR 9809013 (Nov. 7, 1997). Although the municipality asked for a ruling under section 115, the IRS concluded that section 115 did not apply because the

¹⁴ See also PLR 8934052 (May 21, 1989) (arts commission is "corporate and politic," therefore not integral part).

¹⁵ See also PLR 8920056 (Feb. 27, 1989) (An unincorporated city economic development board was not an integral part because the board could hire its own staff who were not considered city employees. The board was created under state statute and funded by taxes, board members were appointed by the city, the city budgeted expenses, the board submitted financial reports to city, city audited the board).

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trust was an integral part of the state. The trust was created by statute to hold and invest amounts contributed by the municipality to fund retiree medical benefits for former public safety officers. The trust was administered by a board, and six of the eight trustees were appointed by program participants (and at the time were active municipal employees although that was not a requirement), and only two were appointed by the municipality. However, the legislative body of the municipality confirmed all appointments. Day-to-day administration was performed by a municipal employee, who was paid by the municipality and participated in the employee benefit system. The municipality provided facilities, equipment, and legal services to the trust. The municipality could amend or terminate the trust at any time, and in the event the trust were terminated, all assets would revert to the municipality. The IRS stated:

If an enterprise is deemed to be an integral part of a state or political subdivision of a state, that enterprise will not be treated as a separate entity for federal tax purposes, regardless of the fact that the enterprise was created as a separate entity.

PLR 9809013.

The IRS determined that it must consider all the facts and circumstances, particularly the state's degree of control over the enterprise and the state's financial commitment to the enterprise. Key factors were that the municipality had made a substantial financial commitment by providing all of the start up money as well as portion of the annual costs. Other important factors included the significant influence exerted by the municipality, its power to amend or terminate the trust at any time, the control over day-to-day operations by a city employee, approval of the board by the city legislative body, and the requirement that the board act only as authorized by the statute. *Id.*

Yet in PLR 9217032 (Jan. 27, 1992), the IRS determined that a mine reclamation trust fund created under state law was not an integral part of the state because it was separately organized as a trust under state law, the trustees had total discretion over the funds, and the trust could accept funds from nongovernmental sources. It is difficult to square this ruling with the later disaster fund rulings, except that it was clearly a separately organized legal entity.

Whether the governing board is appointed by the state or independently elected was a deciding factor in PLR 8944031 (Aug. 7, 1989). That ruling held that a soil and water commission was an integral part of the state, but the soil and water districts were not an integral part because the governing bodies consisted of four independently elected members and only one government appointee.

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Yet another group of rulings echo the MET ruling in considering the source and/or destination of the assets and income of the entity. In 1994, the IRS held that a trust fund created by a state court to collect private contributions to pay for judges' portraits was an integral part of the state. PLR 9439008 (June 30, 1994). The funds were from private sources and there was no financial commitment on the part of the government. A key factor in the ruling, however, were that the court created the trust and controlled it through its ability to select and discharge the state employees who controlled the funds and the trust. Moreover, reflecting the IRS's interest (sometimes) in the destination of funds, the ruling was expressly made contingent on trust documents being amended to provide that any funds remaining after the purposes were met would be delivered to the government's general fund. The ruling concluded that the trust was an integral part of the state, since it was created by the court, controlled by the court officers, and upon termination, any remaining funds would go the state general fund.

In another ruling, the IRS considered a "lifeline" fund, created by the state to subsidize the utility rates of the poor, and concluded that it was an integral part of the state. The fund was created by statute, although it is unclear from the ruling what its legal status was. The funds came from a state-ordered surcharge on utility bills, and were invested until paid out to needy individuals. It was administered by a committee appointed by a state commission. No state officials served on the governing committee. The fund's budget was subject to state review, and annual reports were submitted to the legislature. If terminated, assets would be distributed as ordered by a state public utilities commission, but could not revert to private interests. The IRS concluded that the fund was an integral part of the state due to the state's control over the creation, operation, funding, and supervision of the fund. PLR 8931042 (May 8, 1989). The fact that the assets and income were paid out entirely to private individuals did not seem to merit discussion.

Another recent ruling addressed funds created by state officials from the proceeds of litigation judgments or settlements. The state created two funds to hold settlement payments received as a result of litigation by the attorney general. PLR 9733003 (May 9, 1997). A fund was created in the state treasury to hold litigation judgments or settlements, and was controlled by the treasury department. Distributions from the fund were made pursuant to court order. All income from investment of the fund was deposited in the fund. Fees were paid to the treasurer for investment and administrative services. The fund consisted of two litigation settlements, funds A and B. Settlement A was from state litigation against a trade school. The state court's order required the Attorney General to create a fund, fund A, to receive payments from the defendants for civil penalties, attorneys fees, and restitution to students of the school. In other words, the proceeds in the fund were to be paid as restitution to the individual claimants. The second fund, fund B, consisted of settlement proceeds of antitrust cases

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in federal court brought by the state as *parens patriae* for its residents. The plaintiff class members who were to receive the settlement proceeds in fund B were the state and municipalities.

The state argued that the funds were an integral part of the state.¹⁶ In discussing the "integral part" issue, the IRS noted that the state was involved in the administration of the funds, and state employees, acting in their governmental capacities conducted the funds' business. In both cases, a court controlled distributions and the state remained answerable to the court regarding its administration of the funds.

For fund A, the state controlled disbursement because of the jurisdiction of the state court. The state was not responsible for shortfalls in either fund and did not contribute state funds to either fund. The state did not have the authority to access the assets or income of the funds for the benefit of the state. The state's only financial interest was as a potential claimant. Regarding fund A, the IRS determined that the fund benefited private parties and lacked public benefit, and was not an integral part of the state.

Regarding fund B, the IRS determined that the state lacked the requisite level of control since disposition of the assets and income had to be determined by a federal court. The IRS concluded that the Fund was not an integral part of the state, but rather was a form of receivership imposed on the state by the court.

The litigation settlement ruling is instructive in that it focuses on two concerns of the IRS. The focus on creation and control by the state has long been an element of the "integral part" theory. The focus on "private benefit" however, is a recent development. At times, private benefit appears to be the determining factor, as in this ruling and the MET rulings. Yet just as often, programs such as the disaster insurance programs, that unquestionably have an almost exclusive private benefit are held to be "integral parts" of the state. *See also* PLR 8925010 (March 21, 1989) (city development district is integral part of city even though money reverts to private property owners upon dissolution).

Corporate status does not explain the distinction, since the Hawaii hurricane fund, for example, was a corporation. Curiously, this new destination of income analysis is borrowed from the section 115 analysis, discussed below, and the private benefit focus, which we see in both "integral part" and section 115 rulings, appears to be borrowed from section 501 charitable organization law, which forbids any nonincidental

¹⁶ The state also argued that the income of the funds would be excluded from income under section 115. See discussion below at page 25-32.

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private benefit. It is unclear why the IRS has adopted this analysis, but it is equally clear that not only is it now a key element under section 115, there is a not insignificant likelihood that the IRS may well import it into an "integral part of the state" determination as well.

D. Summary Regarding Integral Part Theory

Overall, we believe that these developments have helped to further elucidate the courts' and the IRS's rationale under the integral part theory in ways that generally are favorable to the fund and the APFC. The MET decision is particularly generous, as are the disaster fund rulings.

Ten years after the Report, the fact that APFC is structured as a corporation continues to give some cause for concern. Commentators have argued that the use of a separate entity, such as a corporation or a trust, must preclude integral part status, and must be analyzed under section 115. This does not seem to be the IRS position, however. Although the rulings of the last 10 years continue to be inconsistent on this point, it appears that, given sufficient indicia of control and financial commitment by the state, a corporation or trust is not automatically precluded from being an integral part of the state.

In this case, the assets and income are not those of the corporation, but rather belong to the State. As a matter of statute, APFC is simply the manager of the Fund assets. This has been reinforced through the 1992 amendment of section 37.13.030 which now plainly clarifies that the assets are managed and invested by APFC, rather than "allocated to" APFC. Similarly, the annual report clearly reports income and assets as those of the Fund, and not the corporation.

Certainly, it would appear that - apart from the corporate structure issue - state creation, control and domination, and declaration of state purpose are essential factors. Similarly, the MET and disaster fund rulings seem to teach that some not significant part of the assets must come from the state, and that it must have some financial risk in the enterprise. The IRS's MET ruling reflects the IRS's evolving but erratic interest in the destination of funds as well although this did not appear to concern the 6th Circuit.

→ A comparison of MET with the Alaska Permanent Fund and APFC is both instructive and reassuring. The key characteristic of the MET and similar prepaid tuition programs, which gives pause to the IRS and, we suspect to any court, is the source and destination of the program funds at issue. The MET may have had all the appearances of being a part of the state, but it was still wholly a private activity conducted by private investors for the benefit of private beneficiaries. The state

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contributed only minimal start-up administrative funds, all of the funds were entirely private funds, the MET's assets were not considered to be state assets, the income was not state income, and upon dissolution, the assets reverted to the investors rather than the state. The IRS-state negotiations over the disaster fund rulings, and subsequent rulings in other areas, discussed below, reveal that the source and destination of the assets and income, as well as private benefit, are becoming significant concerns of the IRS with respect to the integral part doctrine, as well as section 115.

In contrast, the assets and income of the Alaska Permanent Fund are unquestionably those of the state, and not the corporation or any private person. While the legislature has chosen to appropriate certain state funds to the dividend program, the recipients do not have an entitlement to the income of the Fund. If the corporation were dissolved, the assets would remain those of the State, and would not accrue to any individuals. This argument, of course, is premised on the legislature's ultimate control over any allocation, appropriation, or payment to private persons. If at any time, the legislature or government loses that power of appropriation, or private persons are granted an entitlement to the assets or income in the Fund, this argument is considerably weakened.

What plainly bothers the IRS about prepaid tuition programs, although it seemed to be unable to discuss it openly in the MET ruling, is the appropriateness of "lending" the state's tax-exempt status to private investors so they can earn a greater return on their investment than they might otherwise. IRS officials have frequently raised this objection in public discussions of prepaid tuition programs. Apart from tax-exempt bonds, the tax code is full of provisions designed to prevent taxable persons from benefiting from a charitable organization's exemption (e.g., UBIT). The IRS views such programs as opening the door to abuse.

On the other hand, the MET decision and disaster fund rulings indicate that private benefit does not, in all cases, undermine the integral part argument. It would appear from both MET and the disaster fund rulings that sufficient indicia of state control and public purpose can support integral part status, despite the existence of significant private benefit. Obviously, however, it is an open question whether dividend payments to individuals outside the context of a higher education purpose (or governmental pensions, or health insurance claims, or other "approved" governmental or public purpose) will suffice to satisfy the public purpose criterion.

Unfortunately, since the IRS continues to reject the holding and rationale of the 6th Circuit's MET decision, it is clear that it could not be relied on as a basis for obtaining a ruling. Similarly, it likely would provide cold comfort in an administrative proceeding, such as an audit or appeal. We suspect that other courts may well be

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skeptical of its reliance on the political subdivision cases in particular, or its apparent finding that "instrumentality" status is sufficient for exemption under the "integral part" theory.

Although it is difficult to reconcile the IRS's continuing hostility to prepaid tuition plans, which the IRS labels as private investment schemes that seek improperly benefit from the state's exemption, with its generous position on disaster insurance programs, a key distinguishing factor is the element of the state's financial commitment to the enterprise. The IRS insisted that the disaster programs include a significant level of state financial commitment as a source of funds, such as through contributions of funds, earmarking of certain tax or fee revenues, or allowing certain debt obligations to be backed by the state's full faith and credit. In the case of the Fund, it is an essential distinction that the assets clearly are those of the State.

IV. Section 115 Exclusion From Income

The previous Report concluded that the Fund might alternatively claim exclusion of income under section 115, although that position was not entirely free from doubt.¹⁷ Section 115 requires: (1) that the income of an instrumentality be derived from an essential governmental function, and (2) that the income accrue to the State. We noted that the few judicial authorities did not clearly support this argument, yet the IRS appeared to be more liberal than the courts in applying section 115 in the ruling context, particularly with respect to finding "accrual" of income by the State. Since 1988, section 115 has been discussed on only one reported case, *Michigan v. United States*, 802 F.Supp. at 120, described above, which was reversed by the appellate court without discussion of section 115. The IRS has issued one precedential ruling and approximately 170 nonprecedential rulings in this area.

A. Michigan Educational Trust

In *Michigan v. United States*, the state made the alternative argument that the MET's income was excluded from gross income under section 115. In the private ruling, the IRS did not discuss the essential governmental function prong of the statutory test, concluding rather that the accrual requirement was not met because the income served private interests that were more than incidental to the public interest. PLR 8825027 (March 29, 1988). The MET provided direct economic benefits only to

¹⁷ Section 115 and "integral part" theory are not merely alternative arguments. The distinction has important consequences — if the income were excludible under section 115, APFC would be required to file tax returns.

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provide participants who were the beneficiaries of a contract. The IRS stated "The basic principle underlying section 115 is that property (including any income thereon) must be devoted to purposes which are considered beneficial to the community in general, rather than particular individuals." PLR 8825027.

The District Court also did not discuss the "essential governmental function" requirement, although its discussion of the "integral part" claim and 501(c) exemption claim certainly suggest that the Court found that element wanting. *Michigan*, 802 F. Supp. at 123-125. Instead, it held that section 115 did not apply because MET did not satisfy the accrual requirement. 802 F. Supp. at 124. The opinion reaffirmed earlier cases which require an actual or bookkeeping transfer of income to the state, or require that the state have a vested right or enforceable claim to the income. *Id.* In contrast, the MET statute expressly provided that the state had no claim to either MET's assets or income. The possibility of excess assets passing to the state upon dissolution was too remote to constitute "accrual". *Id.* at 124.

The 6th Circuit, having ruled that the MET was an integral part of the state, found it unnecessary to reach the section 115 issue. *MET*, 40 F. 3d at 829. In its discussion of the "integral part" theory, the Court effectively made the case that financing higher education was an essential governmental function, distinguishing *Philadelphia National Bank v. United States*, 666 F. 2d 834 (3d Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982) (which suggested that higher education was not an essential governmental function). We suspect that even the 6th Circuit, had it addressed the section 115 claim, also would have found the accrual element wanting. Under *MSSIC*, potential escheat to the state is not accrual, and the lack of a state financial obligation or risk of state funds is fatal. 308 F. Supp. at 765-766.

B. Rev. Rul. 90-74: Pooled Insurance Funds

The IRS has only issued one authoritative ruling under section 115 since 1988. Rev. Rul. 90-74, 1990-2 C.B. 34, although this ruling has prompted many dozens of private rulings under section 115 addressing pooled risk-sharing or self-insurance funds formed by political subdivisions. These follow Rev. Rul. 90-74, which held that the income of an organization formed, operated, and funded by political subdivisions to pool their casualty risks or other risks concerning public liability, workers compensation, or employee health benefits, is excluded from income under section 115. The key test is whether private interests participate in the organization or benefit more than incidentally from the organization. However, the fact that the purpose of the entity is to insure and reimburse payment of claims to individuals has been held to be an incidental private benefit. PLR 9741002 (June 26, 1997); PLR 9740005 (June 26, 1997); PLR 9646026 (Aug. 20, 1996).

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Rev. Rul. 90-74 illustrates the typical ruling. The political subdivisions agree to create a pooled self-insurance entity, which could be a corporation. *See, e.g.*, PLR 9646026 (Aug. 20, 1996); PLR 9101005 (Sept. 1, 1990).¹⁸ In some cases, the pooling entity was created or authorized by state statute. This did not appear to be a necessary factor, although it supported the finding of essential government function. Each participating body authorized participation in the entity. The board was elected by the member political subdivisions, and controlled the entity. Typically, the state treasurer managed the fund, although this was not the case in all the rulings. Each member contributed funds from general revenues based on actuarial risk determinations. The entity received investment income. The entity reimbursed members for casualty losses. In the event of dissolution, assets would be distributed to member political subdivisions. The rulings held that the investment of funds was a necessary incident of the power of governmental entities to raise revenue and meet expenses. The rulings also concluded that insuring political subdivisions against risk arising from governmental activities also was a governmental obligation. The rulings determined that risk pooling (rather than purchasing commercial insurance) fulfilled the obligations of the political subdivisions to protect their financial integrity. A universal requirement was that no private interests participated in or benefited from the operation of the entities. The IRS concluded that the entities performed an essential governmental function. Regarding the accrual requirement, the rulings observed that, since income was used to reimburse losses incurred by the participating political subdivisions or to reduce their annual fees, and did not benefit private interests, and since assets would be distributed to members upon dissolution, the income accrued to a political subdivision. Any private benefit to employees (*i.e.*, payment of claims) from insuring against these risks was incidental to the public benefit.

C. Section 115 Rulings

Since 1988, the IRS has issued over 170 private rulings under section 115, triple the number during the previous decade. These rulings generally look to *Maryland Savings Share Insurance Corp. v. United States*, 308 F. Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970) ("MSSIC") and Rev. Rul. 77-261, 1977-2 C.B. 45 for guidance.

¹⁸ Apparently, even if these self-insurance entities are not organized as separate corporations, they are treated as such by the IRS (absent exclusion under section 115) because unincorporated entities primarily involved in insurance activities are taxable as corporations. Rev. Rul. 83-132, 1983-2 C.B. 270.

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The key "essential governmental function" factors most often cited in the rulings include state control and domination, the importance of the activity to the state as evidenced by legislation declarations, and the extent of the state's own investment in the enterprise, which indicates whether the state viewed the function as sufficiently essential "to lay its money on the line." The rulings look at the state's investment in the enterprise, whether the state bears the operating costs, and whether the state has committed to meet the liabilities of the enterprise. The key accrual factors seem to be whether income is paid to or credited to the account of the state; whether, upon dissolution, the enterprise's assets will be transferred to the state; and the extent of private benefit.

1. State Investment Funds

In recent years, the IRS has considered investment pools established on behalf of political subdivisions, and has reaffirmed its position in Rev. Rul. 77-261, 1977-2 C.B. 45, that investment of public funds can be an essential governmental function. In PLR 9541030 (Oct. 13, 1995), the IRS ruled that the income of an unincorporated investment pool established by several political subdivisions was exempt from federal taxation under section 115. The purpose was to permit investment of idle funds. The investment objective was maximum current income consistent with the primary objectives of preservation of capital and maintenance of liquidity. The fund members were political subdivisions and their integral parts. A nonprofit corporation was organized solely to govern the fund. The board of the corporation managed and administered the fund; board members were elected by the member political subdivisions. The state treasurer served as president of the corporation and was a board member. The net assets or earnings did not inure to and were not distributed for the benefit of any private persons. Members could withdraw their funds with interest at any time. If the fund dissolved, the net assets would be distributed to the fund member political subdivisions. The IRS relied on Rev. Rul. 77-261, concluding that the fund performed an essential governmental function. The income was used solely to provide benefits to members, which were political subdivisions, and in the event of dissolution, all assets were to be distributed to members. Consequently, the IRS concluded that the income accrued to political subdivisions within the meaning of section 115. However, since the exemption from income was under section 115, the IRS ruled that the fund was required to file a tax return. The ruling did not address the tax status of the nonprofit corporation.

Similarly, in PLR 9435031 (Sept. 2, 1994), the IRS considered a pooled investment fund created for state school districts to invest surplus funds. Because the school districts had the power to tax, it was held that they were political subdivisions. The fund was a public corporation authorized by state statute. It was governed by a board. All but one board member were elected by the participating school districts, and

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were school district employees. The board held legal title to cash and other property contributed by the members. The board could enter into contracts for administrative and custodial services. The investment goals were safety, liquidity, and return on investment. The income could not accrue to a private party. Upon dissolution, assets would be distributed to the members.

The IRS concluded that "[t]he investment of positive cash balances by a state or political subdivision thereof in order to receive some yield on the funds until they are needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and other revenues for use in meeting governmental expenses." Therefore the fund performed an essential government function. Since no part of it accrued to any private party, members could redeem their interest at any time except during emergency situations, and the dissolution clause provided that the assets returned to members. The IRS held that the income accrued to a state or political subdivision. The fund was a wholly-owned instrumentality of the political subdivisions, and its income was excluded under section 115.

This approval of governmental investment activities as essential governmental functions has been criticized by some commentators who favor restricting state exemption from federal taxation. It also potentially creates some tensions with the IRS position on programs like the prepaid tuition programs, where the IRS takes the position that it is not an essential governmental function for the government to lend its own exempt status to the investment activity of individual investors. The IRS faces this difficulty particularly in reviewing programs in which the state indirectly conducts investment activity on behalf of individual beneficiaries.

2. Litigation Settlement Funds

As discussed above, several rulings address funds created by state officials from the proceeds of litigation judgments or settlements. In one case, a state created two funds to hold settlement payments received as a result of litigation by the attorney general. PLR 9733003 (May 9, 1997). Settlement A was from state litigation against a trade school; the proceeds in fund A were paid as restitution to the individual claimants who were former students of the school. The second fund, fund B, consisted of settlement proceeds of antitrust cases in federal court brought by the state as *parens patriae* for its residents. The plaintiff class members who were to receive the settlement proceeds in fund B were the state and municipalities.

The IRS seemed to conclude without discussion that the funds were an essential governmental function. Applying the accrual test, however, the IRS determined that only the income of fund B was excluded from gross income under section 115, since

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that income eventually accrued to the state and municipalities, while private parties received more than an incidental private benefit from fund A.

3. Other Section 115 Rulings

Other rulings under section 115 continue to illustrate that the IRS is, inexplicably, more liberal than the courts in finding both essential governmental function and accrual.

For example, a decedent bequeathed property to a city in trust to be used exclusively to establish and support a library. The IRS recognized libraries as ordinary municipal functions, and concluded that section 115 was met without any analysis of the accrual requirement. PLR 9115016 (Jan. 10, 1991). Although there was no private benefit, there also was not accrual to the city, at least not as it has historically been understood. The city had no control over the library, its assets or income, and under the terms of the bequest, the assets and income could not be used by the city for any other purpose. Thus, the apparent lack of control did not seem to affect the determination of either essential governmental function or accrual.

A mine reclamation fund ruling provides another unusual ruling relating to accrual. PLR 9126027 (March 29, 1991). As part of a mine reclamation program, a state created an insurance program to pay private property owners for land subsidence due to mining. The program was funded by a federal grant. Homeowners paid a fee to participate. Upon termination, the remaining funds reverted to the federal government, not to the state. The ruling determined that such a program was an essential governmental function. It concludes that the accrual requirement was satisfied because all of the income "used to perform the public purpose," which was payments to private landholders. Curiously, there is no discussion of the fact that the entire purpose of the program was a substantial private benefit limited to participants in the program. This would appear to be inconsistent with the IRS's ruling with respect to the Michigan Educational Trust, although it is consistent with the IRS rulings under the "integral part" theory relating to disaster insurance programs.¹⁹

¹⁹ This ruling also is inconsistent with GCM 39006 (June 28, 1983), which reviewed a similar mine subsidence fund which was established by statute but run by insurers. The IRS ruled that the state had no long-term commitment (other than a start-up loan) and received no financial benefit. The beneficiaries were private landowners. The IRS denied exclusion under section 115. PLR 9126027 does not mention GCM 39006, which suggests that the accrual test requires a direct financial benefit to the state.

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D. Summary of Section 115

It is clear from the rulings that the IRS adopts a very broad view that an "essential governmental function" is whatever the state legislative says it is. Most rulings quote Rev. Rul. 77-261, which stated the premise that "it may be assumed that Congress did not desire it any way to restrict a state's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct." *See, e.g.*, PLR 9669634 (Dec. 1, 1995).

For purposes of the accrual test, the IRS has long looked to the destination of the funds and more particularly, looks for benefits to private individuals, which apparently is fatal under section 115 (although apparently not under the "integral part" theory, under the *MET* decision and disaster fund rulings). Certainly in the *MET* ruling, the IRS made its decision based on a private benefit analysis without any actual discussion of accrual. This seems to reflect a trend toward emphasizing a concern with benefits to private individuals over the historical understanding of the accrual test (which required that the income must accrue in a technical sense). *See* Rev. Rul. 90-74. To some extent the IRS appears to use the private beneficiary test as a separate requirement from the accrual test, rather than a part of it, *see, e.g.*, PLR 8825027 (*MET*). On the other hand, there are numerous rulings in which the IRS has granted section 115 exclusion to governmental pension plans, which exclusively pay benefits to individuals. *See, e.g.*, G.C.M. 34704 (Dec. 2, 1971); PLR 8825027 (July 2, 1988). The IRS has not explained how it distinguishes pension plans from prepaid tuition plans in terms of the applicable criteria. One possible explanation is that the rulings also appear to reflect a trend toward examining whether the activity benefits the government financially by relieving it of some present or future financial obligation, which can have the effect of permitting private benefit which is considered "incidental" to the public benefit, resulting in an even more generous application of section 115.

Although there is no authority for this argument, it may be possible to argue under section 115 that any income that does not benefit private parties (*i.e.*, is not transferred to the dividend fund) should be excluded under section 115. We find no rulings addressing whether income can be allocated in this fashion, although the *MET* ruling determined that the payments by the state and investors into the fund were excludible, presumably as some form of "capital" contribution. Section 115 does not purport to characterize all of the income of an entity as taxable or excluded from gross income. Rather it provides that "gross income does not include" income of a certain character. Arguable, income that in fact accrues to the state should be excludible, even if the income that ultimately benefits private persons might not be.

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V. Other Developments

We understand that there have been several factual developments which we believe enhance the Fund's position. These include legislative clarification of the Permanent Fund provisions and other statutory provisions, state court decisions, Attorney General opinions, and perhaps subtle changes in the way the APFC presents itself publicly and in publications such as its annual report. There may well be other developments that we have failed to note here that also serve to enhance the Fund's position in asserting these legal arguments.

For example, AS section 37.13.030, which formerly stated that the Fund's assets were "allocated to" the APFC, was amended in 1992 to state that the Fund's assets were to be managed "by" APFC, thus clarifying that the statute creating the APFC effected no change of ownership. See also AS 37.13.020, .140, .150, .160, .170, .180, .190 for similar changes in reference from APFC to the Fund. In particular, the statute no longer refers to the "net income of the corporation" but rather to the "net income of the Fund." AS 37.13.140.

We note that there have been, over the years, positive albeit subtle changes in the language used by APFC to describe its functions and role *vis a vis* the Fund and the State. The Annual Report plainly indicates that the assets and income are those of the Fund, and that APFC is a state instrumentality which is the investment manager and not the owner. We understand that APFC's accounting procedures record the assets and earnings as those of the Fund, and the earnings reserve account is reported on a public fund model rather than a corporate model.

The Alaska Supreme Court confirmed that the earnings reserve account is subject to legislative appropriation and cannot be spent absent a legislative appropriation. *Hickel v. Cowper*, 874 P.2d 922, 934-935 (Alaska 1994).

Since 1988, several Attorney General opinions have reinforced earlier opinions with respect to the Fund and APFC's relationship to the State and the applicability of certain state laws. For example, the Attorney General determined that all operating funds of the APFC are public funds subject to the constitutional requirement that they be used only for a public purpose, and could not be expended in a manner inconsistent with the government-approved budget. The opinion further concluded that the APFC was subject to the State's Open Meetings Act and the Ethics Act, both of which apply only to governmental agencies. OAG File No. 663-93-0397 (July 6, 1993). Similarly, the AAG determined that the APFC is subject to state contracting and procurement requirements applicable to state agencies. OAG File No. 663-93-0250 (Jan. 26, 1993).

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VI. Conclusion and Recommendations

We continue to recommend that the State take the position that the Fund and APFC are integral parts of the state, and thus not subject to federal taxation, relying on the authorities cited in our prior Report and the MET decision. We recommend that section 115 be presented as an alternative basis for exclusion of income from federal taxation, relying on the authorities cited previously and Rev. Rul. 90-74.

The many rulings issued by the IRS, while not authoritative, are nevertheless instructive. It is clear that many of the factors discussed in rulings relating to legislative purposes, governmental function, and state control are present in the Fund and APFC. See Report at 45-64, 104, 122-25. The recent rulings reinforce the importance of these indicia of state creation, control and domination. While we would reiterate our preference that the Fund be managed by an agency rather than a corporation, the statutory amendments and other changes in the APFC's mode of doing business have done much to relieve this concern. The several rulings granting integral part status to corporations also indicate that although this may be an important threshold consideration for the IRS, it does not appear to be determinative given sufficient evidence of state control and financial commitment.

We continue to be concerned about the potential perception of the dividend fund program as an improper private benefit, particularly in light of the wide-ranging discussion about the future of the Fund and the dividend program. While private benefit has always been an element of the accrual test under section 115, it increasingly appears to be an important criterion of independent significance. The rulings suggest that private benefit is simply impermissible under section 115, other than that incidental to the public purpose (e.g., payment of state employee insurance claims under a pooled insurance program). It is unclear to what extent the income of the Fund, although it clearly accrues to the State, might be considered to ultimately benefit private beneficiaries.

The developments of the last ten years also have revealed the surprising extent to which this concern with private benefit seems to be influencing the IRS' interpretation of the "integral part" theory. Since that theory has been developed in only one case, MET, which the IRS rejects, the IRS presently is to a great extent in a position to interpret "integral part of a state" as it chooses, constrained only by its own prior (and reversible) rulings. On the other hand, the disaster fund rulings seem clearly to suggest that private benefit is not a bar to an entity being characterized as an integral part of the state. In cases where there is significant private benefit, the IRS appears to be willing to overlook it if there is not only sufficient evidence of public purpose and state control, but also a significant state financial commitment such that the assets of the state are at risk in the enterprise. Although this focus on the state's financial commitment does not

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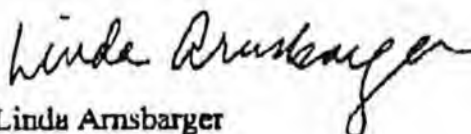
appear to be greatly emphasized in the rulings, it was clearly the guiding principle in the IRS's negotiations with the states regarding those rulings. And certainly that element is satisfied with respect to the Fund.

The private benefit arguably represented by the dividend program continues to fall into a gray area in terms of public purpose. At one end of the spectrum are the approved disaster insurance programs. The IRS found a sufficient governmental purpose to help its citizens protect themselves against natural disasters in the wake of significant disasters with profound economic consequences for the state. The IRS may have been particularly persuaded by the suggestion that, absent such programs, the financial consequences would be borne more directly by the state. At the other end of the spectrum are the prepaid tuition programs, which the IRS characterized as private investment schemes wrapped in the state's cloak of tax exemption. It may be difficult to argue that the dividend program is more like the former than the latter.

We believe that as long as the income from the Fund clearly accrues to the State and no individual has a vested interest in the income or assets of the Fund, the income and assets are those of the State alone, and thus not subject to federal taxation. How the State chooses to appropriate or spend its revenues should have no impact on this determination, except perhaps to further reinforce the argument that the investment activity is an integral part of the State and essential governmental function. And as long as the dividend program is implemented as a matter of legislative grace, we believe that it will be difficult for the IRS to argue that, having earned the income (investment being an appropriate public purpose and essential governmental function), it is not entirely within the discretion of the State to appropriate it: as it sees fit, whether through legislative allocation or annual budget appropriations.

Conversely, to the extent that the Fund, or some portion of it, becomes irreversibly dedicated to the benefit of private beneficiaries, or to the extent that the dividend program becomes an entitlement that is beyond the reach of the government, then it becomes more like the prepaid tuition programs and is subject to potential challenge by the IRS as a private, rather than public, investment activity.

Sincerely,


Linda Arnsbarger

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dc-111890

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FISCAL NOTE

Bill Version: CSHJR 49 (STA)

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**STATE OF ALASKA
2000 LEGISLATIVE SESSION**

Revision Date/Time (Note if correction) _____ Dept. Affected Office of the Governor
 Title Constitutional Amendment relating to the BRU Elective Operations
permanent fund income distribution Component Elections
 Sponsor Representative Ogan
 Requester House State Affairs Committee Component No. 21

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Personal Services						
Travel						
Contractual	1.5					
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	1.5	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
-----------------------------	--	--	--	--	--	--

CHANGE IN REVENUES ()						
-------------------------------	--	--	--	--	--	--

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF	1.5					
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type)						
TOTAL	1.5	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2000) cost: 0.0

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This figure includes the cost of providing information about this issue in the Official Election Pamphlet, as required by AS 15.58. However, only six measures can be printed on an 8-1/2 by 14 inch ballot. If this measure requires printing an 8-1/2 by 18 inch ballot, the cost will increase by \$22.0.

Prepared by: Gail Fenwick
 Division: Division of Elections
 Approved by: Lt. Governor Fran Ulmer
 Agency: Office of the Lieutenant Governor

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 Date/Time: 3/31/00 2:46 PM
 Date: 03/31/2000

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