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LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES LEGISLATIVE AFFAIRS AGENCY STATE OF ALASKA

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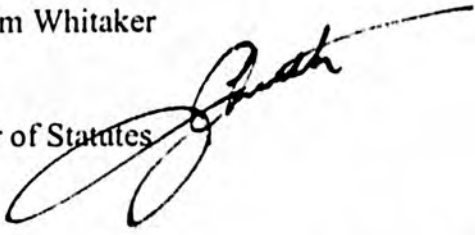
MEMORANDUM

February 5, 2000

SUBJECT: Qualification of the "Alaska Gasline Port Authority" as a political subdivision for purposes of United States Internal Revenue Code (26 U.S.C.)

TO: Representative Jim Whitaker

FROM: Jack Chenoweth
Assistant Revisor of Statutes



I am responding to a request from Lori Backes to provide an explanation of my understanding of the Internal Revenue Service's recent ruling issued to the Alaska Gasline Port Authority.

The United States Treasury Department's January 24 document identifies itself as a "ruling letter"^{1/} determining that the Alaska Gasline Port Authority, jointly established by the Fairbanks North Star Borough, North Slope Borough, and the City of Valdez, enjoys the status of a "political subdivision" for purposes of the Internal Revenue Code (26 U.S.C.). Treasury reached the conclusion based on its application of the appropriate tests set out in the Internal Revenue Code and related regulations and previous precedents cited in the department's Revenue Rulings and a Tax Court decision.

As a consequence of the ruling, for federal income tax purposes, income earned by the bondholder from interest paid on the debt obligations issued by the Authority to finance construction and operation of a proposed gasline and related facilities and improvements is

^{1/} Treasury regulations identify a "ruling," a type of "written determination," as

... a written statement issued by the National Office to a taxpayer or to the taxpayer's authorized representative on behalf of the taxpayer, that interprets and applies tax laws to a specific set of facts. A ruling generally recites the relevant facts, sets forth the applicable provision of law, and shows the application of the law to the facts.

Representative Jim Whitaker
February 5, 2000
Page 2

to be treated as tax exempt.^{2/} That income, by analogy, would be handled, for purposes of determining the taxpayer's tax liability, as the equivalent of tax-exempt municipal debt issues.

As a caution, I should add that, to maintain the favorable tax status of its obligations, the Authority should make every effort to manage its anticipated revenue within the parameters discussed by the Treasury official in the opinion. Those parameters are identified in the letter as "[i]ndicia that the Authority is governmentally controlled" and are enumerated on page 3 of the letter as follows:

. . . (1) the Authority is governed by a board of directors appointed by its member governmental units . . . ; (2) the Authority's net revenues inure to the benefit of the State and its municipalities; and (3) the Authority's assets will be distributed to its member governmental units upon dissolution. The Authority is motivated by a wholly public purpose.

The three enumerated provisions have parallel references in the ordinances of the three participating municipalities. The last sentence set out in the quoted material is conclusory but finds support in the recitals set out in the uncoded language of each of the enacting ordinances. Modify any of those provisions in a way that suggests that the governmental control and public purpose features are diminished or extinguished and Treasury may reconsider its conclusion.

JBC:Imb
00-005.lmb

^{2/} 26 U.S.C. 103 makes the interest on the obligations of a state or its political subdivisions excludable from the gross income of the holder of the obligation in determining the federal income tax obligation of the holder.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES LEGISLATIVE AFFAIRS AGENCY STATE OF ALASKA

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MEMORANDUM

March 22, 1999

SUBJECT: Exemption of the income or earnings of the proposed Alaska Gas Corporation from federal income taxation (Work Order No. 21-LS0694A)

TO: Representative Jim Whitaker

FROM: Jack Chenoweth
Assistant Revisor of Statutes

QUESTION PRESENTED: You have inquired as to whether the proposed Alaska Gas Corporation, to be established by law as a public corporation, may be structured so that the earnings or income from its activities will not be subject to taxation under the federal income tax, 26 U.S.C.^{1/}

SHORT ANSWER: The Internal Revenue Code provides that income derived from a public utility or from the exercise of any essential government function is exempt from federal income taxation if the income accrues to a state or a political subdivision of a state. I am of the view that the activities contemplated by the proposed Alaska Gas Corporation would not

^{1/} Your transmittal memo noted that income of the Alaska Permanent Fund Corporation, Alaska Railroad Corporation, and Alaska Housing Finance Corporation is not subject to federal tax.

The income of the Railroad Corporation enjoys an explicit exemption from federal income taxation under 45 U.S.C. 1207(a)(6)(A). I assume that the Internal Revenue Service views the Alaska Housing Finance Corporation as simply a device (in the form of a corporation) that performs a function, improvement of housing opportunity, that constitutes an essential government function, not unlike that performed in all other states, and refrains from asserting that the corporation's net income may be subject to taxation.

More problematical is the IRS's treatment of the income earned by the Alaska Permanent Fund. However, so long as the Permanent Fund Corporation undertakes to do what the state itself would otherwise perform directly for itself, investment of "surplus" revenue, with the earnings accruing generally to the state, the IRS should continue to avoid asserting that the corporation's income is subject to tax.

As to these each of these three, if their activities begin to involve them in substantial "private" activities or in activities that do not constitute essential functions of government, the exclusion from federal income taxation of at least part of the earnings of the respective corporation may be lost.

qualify the corporation as a public utility.^{2/} Thus, the requirements of the test really must concentrate on meeting the remaining two standards: the exemption from taxation applies

- if the activity involves an essential government function; and
- if the corporation's income accrues to the state.

To the extent the Alaska Gas Corporation acts to manage state assets, its activities arguably should qualify the corporation as something that performs an essential government function, leaving its earnings exempt from taxation under the Internal Revenue Code. However, exclusion of the income from federal income taxation is not entirely free from doubt. There are various reasons the Internal Revenue Service might decide that the earnings or income of the corporation may be taxed.

In addition, due to the so-called "accrual" requirement, the drafting of the legislation must ensure that the corporation's activities meet the minimum requirements that attach to this state's having a claim on some portion of the corporation's income.

If both requirements cannot be met, exclusion of income from taxation would be foregone. It may be necessary for the state to ask the Congress for a specific tax exemption (as has been previously provided for the Alaska Railroad Corporation).

DISCUSSION: The Internal Revenue Code, 26 U.S.C., provides for the levy and collection of taxes on individuals, corporations, and others. States, political subdivisions of states, and some of their instrumentalities have been treated by the Internal Revenue Service as not subject to the tax provisions of the Code. Income earned by states and political subdivisions has escaped federal income taxation. However, when states and political subdivisions establish wholly-owned corporations (and similar entities) to conduct or engage in public activities, unless there is a specific provision maintaining the corporation's tax-exempt status, the corporation's earnings *may* be subject to federal income taxation.

The principal Code provision applicable to the income earned by states and their political subdivisions is 26 U.S.C. 115(1), the relevant portion of which reads:

Gross income does not include --

- (1) income derived from any public utility[/]or the exercise of any essential governmental function and accruing to a state or any political subdivision thereof,
....;

Courts have applied 26 U.S.C. 115(1) to determine the tax status of entities other than states and their political subdivisions. City of Bethel v. United States, 594 F.2d 1301 (9th Cir. 1979), *cert. denied*, 444 U.S. 980, 62 L.Ed.2d 407 (1979) (Ninth Circuit applied 26 U.S.C.

^{2/} The proposed Alaska Gas Corporation may not qualify as a public utility because its services would not be held out to be generally available to all or a substantial portion of the public, but rather are intended to aid *the state* in the marketing of its resources.

115(1) to evaluate asserted exemption from taxation of income of liquor store corporation that was wholly-owned by the city).

In taking the measure of whether the income of a public corporation is or is not tax exempt, the Internal Revenue Service concerns itself, first, with whether or not the income earned follows from "the exercise of [an] essential governmental function" and, second, whether the income generated by the entity engaged in the activity accrues to the state. Both parts of the test must be met if, under the application of 26 U.S.C. 115(1), the income is to escape federal income taxation.

I

There are cases on each side that consider whether the performance of a particular service qualifies as an "essential governmental function." For example, operation of the Port of New York Authority by the states of New York and New Jersey, designed to construct and operate transportation facilities on behalf of the two states, qualifies as an "essential government function" under an early New Jersey state court opinion.^{3/} On the other hand, for purposes of determining federal tax liability, a public university's operation of a commercial television station does not qualify.^{4/} The significant distinguishing characteristic may well be whether the particular service qualifies because of a duty imposed under the state's own constitution or, in the absence of a constitutional obligation, because it is either a function or duty arising in conjunction with the administration of government (e.g. investment of surplus revenues, a principal responsibility of the Alaska Permanent Fund Corporation) or with the exercise of a sovereign power of the state affecting the public. What does seem clear is that, in order to avoid a claim that the service does not qualify as an "essential government function," the service provided may not yield any more than an incidental benefit to one or more private parties, on the theory that a service does not qualify as an "essential government function" if it is done for the particular benefit of less than substantially all of the public.

II

26 U.S.C. 115(1) allows an exemption only if the corporation's income actually "accrues" to the state--that is, so long as it is received or transferred to the state.^{5/} It is not enough that, in this instance, the state have the control of the corporation.^{6/} The test appears to be whether

^{3/} Miller v. Port of New York Authority, 15 A.2d 262, 266 (N.J. 1939).

^{4/} Iowa State University of Science and Technology v. United States, 500 F.2d 508 (Ct. Cl., 1974).

^{5/} Under the earlier-cited City of Bethel decision, the Ninth Circuit disallowed tax exempt treatment of the income of the city-owned liquor store's because the arrangement between the city and the corporation did not require a distribution of profits to the municipality.

^{6/} Bear Gulch Water Co. v. Commissioner of Internal Revenue, 116 F.2d 975 (9th Cir. 1941), *cert. denied* 314 U.S. 652, 62 S.Ct. 99 (1941) (a corporation's retained earnings do not
(continued...))

or not the state has reserved to itself a right or enforceable claim to the corporation's net income. So, for example, in the City of Bethel decision, cited earlier, the Ninth Circuit noted that the city could have met the requirement by requiring the liquor store corporation's trustees to distribute the corporation's profit under a clause of the articles of incorporation: "The balance, if any, of all money received by the corporation from the operations of its liquor store, after the payment in full of all debts and obligations of the corporation of whatever kind or nature, shall be distributed exclusively to the [c]ity . . . for use in promotion of the general welfare of the [c]ity and its inhabitants." 594 F.2d at 1303, n. 6. The court declared that "[i]f the income had been transferred to Bethel coffers and ~~the~~ expended to finance [the city liquor store's] operations, a different result might follow Instead, the income was retained [by the city liquor store corporation] . . . [and] Bethel's financial records [did not] reflect any right to receive [the] income"

*

I can only suggest that, as it considers the proposed Alaska Gas Corporation, the legislature give careful consideration to each of the following points:

-- the legislation should try to avoid situations involving a commitment or involvement of the corporation's earnings in activities giving anything more than incidental benefit to one or more private parties, for providing that kind of treatment might come to be viewed and treated by the Internal Revenue Service as unrelated business income not excludable from taxation under the "essential governmental function" language of 26 U.S.C. 115(1);

-- the legislation should include some means that, as the Ninth Circuit related in City of Bethel, requires a distribution of net income (after provision for payments of debts and for reserves for obligations) to the state for deposit into the state treasury.

If compliance with one or both of these proves detrimental to achieving the stated purposes of the legislation, you may want to ask Congress to provide an express tax exemption.

*

If this memo prompts questions, please contact me.

JBC:glc
99-119.glc

⁶(...continued)

accrue to a government entity for purposes of sec. 115(a) even though the corporation's stock is wholly owned by the government entity).

November 19, 1999

Internal Revenue Service
Assistant Chief Counsel
Financial Institutions & Products
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Attn: CC:DOM:CORP:TSS, Room 6561

Re: *Alaska Gasline Port Authority*

Ladies and Gentlemen:

This letter ruling request is respectfully submitted on behalf of the Alaska Gasline Port Authority (the "Authority" or the "Alaska Gasline Port Authority").

IN BRIEF, A RULING IS REQUESTED TO THE EFFECT THAT, UNDER THE FACTS SET FORTH HEREIN, THE AUTHORITY IS A POLITICAL SUBDIVISION OF THE STATE OF ALASKA (THE "STATE"), AND THEREFORE, THE AUTHORITY'S INCOME IS EXEMPT FROM FEDERAL INCOME TAXATION.

II. RULINGS REQUESTED

The Authority requests a ruling that:

The Authority is a political subdivision of the State, whose income is exempt from federal income tax.

Internal Revenue Service**Department of the Treasury**

Index Number: 103.02-01

Washington, DC 20224

Travis C. Gibbs
c/o O'Melveny & Myers LLP
400 South Hope Street
Los Angeles, California 90071-2599

Person to Contact:

David E. White I.D. #50-07783

Telephone Number:

(202) 622-3980

Refer Reply To:

CC:DOM:FI&P:5/PLR-118656-99

Date: JAN 24 2000

LEGEND:

Authority = Alaska Gasline Port Authority

State = Alaska

Date 1 = October 5, 1999

A = Fairbanks North Star Borough

B = North Slope Borough

C = City of Valdez

Port = Port of Valdez, Alaska

Location = North Slope of Alaska

Dear Mr. Gibbs:

This letter is in response to your request for a ruling that based on the definition of the term "political subdivision" in § 1.103-1(b) of the Income Tax Regulations, the Authority qualifies as a political subdivision of the State.

Facts and Representations

You make the following factual representations. The Authority was created on Date 1 pursuant to State law by the local governmental units A, B, and C. The Authority was created to provide for the development of ports in the State for transportation-related commerce. In accordance with this purpose, the Authority will

Bonds / Revenue

undertake various improvements and additions to certain existing port facilities located, and will construct new port facilities to be located, at the Port, and will acquire and develop the facilities necessary for the transportation, in state use, and sale of natural gas that is currently stranded at the Location (the "Project").

As a result of the availability of natural gas through the Project, the cost of electricity to the State's residents will be substantially reduced. Excess gas not used in-state will be available for other uses.

The Authority is governed by a board of directors appointed by its member governmental units A, B, and C. The Authority has the power to acquire, by purchase, lease, contribution, condemnation, or otherwise, real and personal property for the Project. State law provides that the Authority has the same power of eminent domain as that possessed by A, B, and C. Specifically, the Authority may commence eminent domain actions, in its own name, in the appropriate court of the State to acquire land or materials within its physical boundaries for Authority purposes, and may take possession of the property upon commencement of the proceedings.

The Authority's revenues will be derived primarily from the sale of natural gas to municipalities within the State and to other purchasers, which are expected to include governmental and private entities. These revenues will be used first generally to pay operating expenses and debt service and to fund necessary reserves for operation of the Project. Any net income will be shared with the State and all of its municipalities for use in their respective governmental purposes. Upon dissolution of the Authority, its assets will be distributed to its member governmental units.

In addition to contributions from the participating governmental units, the Authority is authorized to issue bonds or any other form of indebtedness to raise funds to finance the Project.

Law and Analysis

Section 103(e) of the Internal Revenue Code provides, in part, that except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(c)(1) provides that the term "state or local bond" means an obligation of a state or political subdivision thereof.

Section 1.103-1(b) provides that the term "political subdivision" denotes any division of any state or local governmental unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any state or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such

as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of these units. Rev. Rul. 78-276, 1978-2 C.B. 256, states that the term "political subdivision" has been defined consistently for all federal tax purposes as denoting either (1) a division of a state or local government that is a municipal corporation, or (2) a division of such state or local government that has been delegated the right to exercise sovereign power.

In determining whether an entity is a division of a state or local governmental unit, important considerations are the extent the entity is (1) controlled by the state or local government unit, and (2) motivated by a wholly public purpose. Revenue Ruling 83-131, 1983-2 C.B. 184.

The three generally acknowledged sovereign powers are the power to tax, the power of eminent domain, and the police power. See *Commissioner v. Estate of Alexander J. Shenberg*, 3 T.C. 131, (1944) *acq.*, 1945 C.B. 6, *aff'd* 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945). It is not necessary that all three powers enumerated in *Shenberg* be delegated. Rev. Rul. 77-164, 1977-1 C.B. 20; Rev. Rul. 77-165, 1977-1 C.B. 21. However, possession of only an insubstantial amount of any or all sovereign powers is not sufficient. All of the facts and circumstances must be taken into consideration including the public purposes of the entity and its control by a government.

Indicia that the Authority is governmentally controlled are: (1) the Authority is governed by a board of directors appointed by its member governmental units A, B, and C; (2) the Authority's net revenues inure to the benefit of the State and its municipalities; and (3) the Authority's assets will be distributed to its member governmental units upon dissolution. The Authority is motivated by a wholly public purpose.

Under State law the Authority is granted broad powers of eminent domain within its physical boundaries. The Authority is authorized to commence actions in the appropriate court of the State to enforce this right and will be able to take possession of property upon commencement of the condemnation proceedings rather than after judgment. These exercises of the power of eminent domain are commensurate with a substantial exercise of that power.

Conclusion

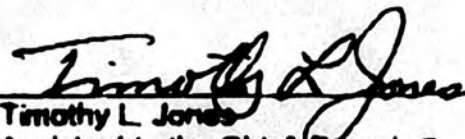
Based solely on the representations made and the definition of the term "political subdivision" in § 1.103-1(b), we conclude that the Authority is a political subdivision.

Except as specifically stated above, no opinion is expressed regarding the consequences of this transaction under any provision of the Code or regulations thereunder.

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

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: 
Timothy L. Jones
Assistant to the Chief, Branch 5

Enclosure:

Copy of § 6110 purposes

cc: District Director, Pacific - Northwest District (Seattle)
Attn: Chief, Examination Division

Employee Plans & Exempt Organizations
Field Compliance Division
Attn: Joseph P. Grabowski, CP: E: EO, T: S
Room 6238

Points Made by Chenoweth, regarding IRS ruling:

1) The IRS ruling only refers to section 103, dealing with taxability of interest earned on bonds.

***Travis' response is that that is the section that defines "political subdivision", and it would be redundant to state that it is income tax exempt.**

2) The IRS ruling, on page 4, states *"Except as specifically stated above, no opinion is expressed regarding the consequences of this transaction under any provision of the Code or regulations thereunder."*

Jack feels that that means this ruling may not be construed to imply anything else, under any other code.

3) Jack also referred to his March 22, 99 opinion on HB170 Alaska Gas Corporation , that the Alaska Gas Corp income would not necessarily be tax exempt.

Travis pointed out that the Alaska Gas Corp would be a "politically created entity", and that the Port Authority is a "political subdivision". Two distinctly different animals.

Sp. Porter
 Smalley
 Harris
 Dyson
 Ch. Whitaker
 Brice
 Phillips
 Niemlen
 Green

Purpose of our meeting today is to hopefully
 clear the air, and remove any question as to the
 effect of a recent IRS Ruling in response to
 a request from the Alaska Gasline Port Authority

To that end

Bill Walker // Travis Gibbs
 General Council // ~~For~~ An Attorney with the firm of
 for the Port Authority O'Melveney, Meyers // Specializing in
 Tax matters