

## Rev. Rul. 90-74, 1990-2 CB 34

### ISSUE

If political subdivisions of a state create, fund, and operate an organization to pool the casualty risks of the participating political subdivisions, is the income of the organization excluded from gross income under section 115(1) of the Internal Revenue Code? <Page 35>

### FACTS

X is a non-profit organization incorporated under the laws of State A. County governments may, under the laws of State A, form and become members of X to pool the casualty risks of the participating counties. The governing body of each county must authorize the county to join X and must designate an individual to represent the county at meetings of X. The board of directors, elected by and from the representatives of the counties, controls X.

Each member appropriates funds from its general revenues to pay to X an initial deposit and an annual fee based upon its size and its actuarially determined level of risk. X also receives investment income. X reimburses its members for any casualty losses. In the event of dissolution, X will distribute its assets to its members.

### LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or political subdivision.

The determination whether a function is an essential governmental function depends on the facts and circumstances of each case. Rev. Rul. 77-261, 1977-2 C.B. 45, concludes that the income of a fund, established under a written declaration of trust to pool the temporary investments of the state and its political subdivisions, is excludable from gross income under section 115(1) of the Code. The fund was authorized by state statute, managed by the state treasurer, and benefited only the state and its political subdivisions. The ruling states that the investment of funds is a necessary incident of the power of governmental entities to raise revenue and meet expenses.

Political subdivisions insure against casualty risks and other risks arising from employee negligence, workers' compensation statutes, and employee health obligations. Insuring against these risks satisfies governmental obligations. Any private benefit to employees from insuring against these various risks is incidental to the public benefit.

Pooling casualty risks through *X* instead of purchasing commercial insurance fulfills the obligations of the political subdivisions to protect their financial integrity. *X* is created under authority granted by the governing body of each participating county and State A. Except for the incidental benefit to employees of the participating political subdivisions described in the preceding paragraph, no private interests participate in or benefit from the operation of *X*. Accordingly, *X* performs an essential governmental function.

Section 115(1) of the Code also requires that the income accrue to a state or a political subdivision. In Rev. Rul. 77-261, a state and the participating political subdivisions had an unrestricted right to receive a proportionate share of the income earned by a joint investment fund. The ruling states that section 115(1) does not require that the income in question accrue only to a state or a single political subdivision and concludes that the income accrues under section 115(1), even though more than one governmental entity participated in the fund.

The income of *X* is used to reimburse casualty losses incurred by the counties or to reduce the annual fees that the member counties would otherwise be required to pay to the organization. The income of *X* does not benefit private interests. Furthermore, upon dissolution, *X* will distribute its assets to its members. Therefore, the income of *X* accrues to a political subdivision within the meaning of section 115(1) of the Code.

## HOLDING

The income of an organization formed, operated, and funded by political subdivisions to pool their casualty risks is excluded from gross income under section 115(1) of the Code. Similarly, the income of an organization formed, operated, and funded by one or more political subdivisions (or by a state and one or more political subdivisions) to pool their risks in lieu of purchasing insurance to cover their public liability, workers' compensation, or employees' health obligations is also excluded under section 115(1) if private interests do not, except for incidental benefits to employees of the participating state and political subdivisions, participate in or benefit from the organization.