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September 22, 2003

The Honorable Gregg D. Renkes
Attorney General
State of Alaska
Department of Law
123 4th Street, 5th Floor
Juneau, AK 99801-1141

Re: Federal Income Tax Status of Alaska Permanent Fund and Alaska Permanent Fund Corporation

Dear Mr. Renkes:

You have requested our opinion concerning the application of the federal income tax laws to the Alaska Permanent Fund ("APF" or "Fund") and the Alaska Permanent Fund Corporation ("APFC" or "Corporation"). Specifically, you have asked:

1. Whether the Fund or the Corporation, as currently constituted, is subject to federal income tax;

2. Whether incorporating into the Alaska Constitution (the "Alaska Constitution" or "Constitution") a requirement for a payment of a dividend to residents of Alaska from the Fund, generally known as the permanent fund dividend, would affect the federal income tax status of the Fund or the Corporation; and

3. Whether providing in the Constitution that a portion of earnings from the Fund must be used to defray the State's obligations to fund public education would affect the federal income tax status of the Fund or the Corporation.

As more fully explained below, in our opinion, the Fund, as currently constituted, should not be subject to federal income tax because it is an asset of the State of Alaska and its income is earned directly by the State of Alaska or, in the alternative, because it is an integral part of the State of Alaska. We further conclude that the Corporation, as currently constituted, should not be subject to federal income tax because it is an integral part of the State of Alaska or, in the alternative, because its income, if any, is excluded from federal income tax under Section 115(1) of the Internal Revenue Code (the "Code").

Further, and as more fully explained below, in our opinion, the adoption of constitutional amendments incorporating into the Constitution a requirement for payment of the permanent fund dividend and a requirement that a portion of Fund earnings be used to defray the State's obligations to fund public education should not change this result.

In preparing our opinion, we have reviewed prior tax opinions regarding the federal income tax status of APF and APFC that you provided to us, the pertinent provisions of the Alaska Constitution, the Alaska Statutes,[1] and relevant interpretations of federal income tax law. The opinions and conclusions expressed herein are based on our understanding of the facts set forth below and are subject to any limitations or conditions expressed herein. Further, our opinions and conclusions are based on the law as of the date of this letter, and we assume no obligation or responsibility to update them in the event of a change in law, regulation, or administrative or judicial interpretation, regardless of whether such change applies retroactively.

I. Statement of Facts

A. Alaska Permanent Fund ("APF")

1. Establishment and Purpose of APF

APF was established in 1976 by a voter-approved amendment to the Alaska Constitution. Alaska Const. art IX, § 15 (effective Feb. 21, 1977). Article IX, Section 15 of the Alaska Constitution provides:

> At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.

According to the legislative findings set forth in Section 37.13.020 of the Alaska Statutes, the purposes of the Fund are to "provide a means of conserving a portion of the state's revenue from mineral resources to benefit all generations of Alaskans; . . . to maintain safety of principal while maximizing total returns; [and to be] a savings device managed

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[1] For interpretations of state law, we have relied on opinions of the Alaska Attorney General and interpretations of such opinions by Alaska courts. Courts in Alaska have given "great weight" to the Attorney General's opinions on matters of statutory interpretation. *See Myers v. AHFC*, 68 P.3d 386, 392 n.2 (Alaska 2003).

to allow the maximum use of disposable income from the fund for purposes designated by law."

The Alaska Constitution does not specify the organizational form of the Fund. The Fund is treated as a segregated permanent fund on the State's books without its own legal identity. The Fund's annual reports and the legislative history of the Fund, as compiled by the Rural Research Agency in 1986 on request from the Alaska legislature, refer to the fund as a "trust."[2] The Permanent Fund Dividend Division, a division of the Department of Revenue that is responsible for dividend distributions from the Fund, characterizes the Fund on its website as a "savings trust."[3] The Fund also has been characterized as a "savings account."[4]

APF is managed by the Alaska Permanent Fund Corporation ("APFC"), which is described in the Alaska Statutes as a "public corporation and government instrumentality in the Department of Revenue." Alaska Stat. § 37.13.040. The Fund is exempt from all state taxes and assessments. Alaska Stat. § 37.13.180.

2. Funding

As provided in the Alaska Constitution, Article IX, Section 15 and Section 37.13.010(a) of the Alaska Statutes,[5] APF derives revenues from the following sources:

1. 25% of all mineral lease rentals, royalties, royalty sale proceeds, net profit shares, bonuses and federal mineral revenue sharing payments; and

2. any other money appropriated to or otherwise allocated by law to APF.

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[2] *See* APF 2002 Annual Report, *available at* http://www.apfc.org/library/AnRptArch.cfm?s=5; Alaska's Permanent Fund, Legislative History, Intent and Operations, Rural Research Agency Report (Jan. 1986), *abridged for The Trustee's Papers Vol. 5*, *available at* http://www.apfc.org/library/tp5.cfm?s=5.

[3] *See Division Overview, available at* http://www.pfd.state.ak.us/OVERVIEW.HTM.

[4] *See History of the Fund and of Alaska, available at* http://www.apfc.org/library/pfhistory.cfm?s=5; APF 2002 Annual Report (Preamble), *available at* http://www.apfc.org/library/AnRptArch.cfm?s=5.

[5] *As amended by* 2003 Alaska Sess. Laws ch. 22, § 3.

APF received its first deposit of dedicated oil revenues in the amount of $734,000 on February 28, 1977.[6] Since then, a percentage of mineral revenues has been paid monthly to APF as required by the Alaska Constitution and Section 37.13.010 of the Alaska Statutes. In 1980, the legislature made a special appropriation of $900 million from surplus oil revenues to APF.[7] In the same year, the legislature raised APF's share of oil royalties for fields leased after 1979 from 25% to 50%.[8] From 1981 to 1985, the legislature made special appropriations from the general fund to the APF totalling $2.7 billion.[9] In 1987, the legislature transferred, by special appropriation, $1.26 billion of undistributed APF income back to the principal of APF.[10] In 1996, the legislature appropriated $1.84 billion of APF income to APF's principal. In 1997, the legislature appropriated another $803 million of APF income to APF's principal.[11] In 2000, the legislature appropriated another $250 million to APF principal. In 2003, the legislature appropriated all but $100 million of the remaining balance in the earnings reserve, an amount totaling $354 million, to APF's principal. *See* 2003 Alaska Sess. Laws ch. 82, § 67(2).

In 1982, the Alaska legislature, at the request of the APFC board of trustees, enacted a statute to protect the principal of the Fund from erosion through inflation. Alaska Stat. § 37.13.145(c). Annually since 1983, a portion of APF income has been transferred to principal to offset the effect of inflation.

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[6] *See Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryB.cfm?s=5 (1976-1983).

[7] *See Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryB.cfm?s=5 (1976-1983).

[8] In 2003, this percentage was rolled back to 25%, but can return to 50% if the impact on the permanent fund dividend exceeds $20. *See* Alaska Stat. § 37.13.010(a), *as amended by*, 2003 Alaska Sess. Laws ch. 22, § 3. *See also Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryB.cfm?s=5 (1976-1983).

[9] *See Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryB.cfm?s=5 (1976-1983); http://www.apfc.org/library/FundHistoryC.cfm?s=5 (1984-1988).

[10] *See Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryC.cfm?s=5 (1984-1988).

[11] *See Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryD.cfm?s=5 (1989-2003).

APF's assets reached $5 billion by 1984.[12] In 1986, the Fund's annual net income exceeded $1 billion for the first time.[13] As of June 30, 2003, APF's market value was $24.2 billion.

The Division of Finance of the State of Alaska reports the assets and earnings of APF in the State's annual financial statements.[14] APF and its income are considered by Moody's and Standard & Poor's for purposes of establishing the state's bond ratings.[15]

3. Disposition of Income

The Alaska Constitution requires that the income of APF be deposited in the general fund of the State of Alaska, unless otherwise provided by law. *See* Alaska Const. art. IX, § 15. Thus, the legislature determines how the income from the Fund will be spent. As discussed below, the legislature has enacted several provisions that provide for income to be deposited in funds other than the general fund.

Income from the Fund is deposited as earned into an earnings reserve account that is established as a separate account in the Fund. Alaska Stat. § 37.13.145(a). Net income of the Fund is computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains and losses. Alaska Stat. § 37.13.140.

At the end of each fiscal year, the income of the Fund is disposed of as follows. A portion of the income, specified by statute, is transferred from the earnings reserve account to a separate dividend fund (the "Dividend Fund") to be distributed to residents of Alaska. Alaska Stat. § 37.13.145(b). After the transfer to the Dividend Fund, an amount sufficient to offset the effect of inflation on the principal of the Fund during that fiscal year is transferred from the earnings reserve account to the principal of the Fund. Alaska Stat. § 37.13.145(c). Any balance remaining after transfers to the Dividend Fund and to the principal of the Fund to offset inflation is retained in the earnings reserve account and is available for legislative appropriation. *See* Alaska Stat. § 37.13.145. No portion of the balance can be disbursed without legislative action. *Hickel v. Cowper*, 874

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[12] *See Landmarks in Permanent Fund History, available at* http://www.apfc.org/library/FundHistoryC.cfm?s=5 (1984-1988).

[13] *See Landmarks in Permanent Fund History, available at*, http://www.apfc.org/library/FundHistoryD.cfm?s=5 (1989-2003).

[14] *See, e.g.*, State of Alaska Department of Administration, Division of Finance, Comprehensive Annual Financial Report, FY 2002 at p. 22.

[15] Memorandum from Debt Manager, Treasury Division to Alaska Permanent Fund Corporation (Sept. 18, 2003).

P.2d 922, 934 (Alaska 1994); 1983 Inf. Op. Att'y Gen. File No. 366-484-83 (March 10, 1983).

The Dividend Fund program was enacted by the Alaska legislature in April 1980. The purposes of the program are (1) to provide equitable distribution of a portion of the State's energy wealth to Alaskans; (2) to encourage people to remain Alaska residents, thereby reducing population turnover in the state; and (3) to encourage awareness and interest in the management of the Fund. 1980 Alaska Sess. Laws ch. 21, § 1(b). Pursuant to this program, 50% of the income of APF that is "available for distribution" is transferred to the Dividend Fund. Alaska Stat. § 43.23.045; Alaska Stat. § 37.13.145(b). Income "available for distribution" equals 21% of the net income of the Fund for the last five fiscal years, including the fiscal year just ended, up to the amount of net income of the Fund for the fiscal year just ended, plus the balance in the earnings reserve account. Alaska Stat. § 37.13.140. The Dividend Fund is a separate fund in the State Treasury administered by the Commissioner of Revenue. Alaska Stat. § 43.23.045(a). The Commissioner of Revenue, through the Permanent Fund Dividend Division in the Department of Revenue, annually pays dividends from the Dividend Fund to eligible recipients. Alaska Stat. § 43.23.025. The size of each year's dividend is calculated using a formula that takes into account the amount in the Dividend Fund available for dividend payments and the number of individuals eligible to receive a dividend in that year. *Id.* The first dividend, in the amount of $1,000 per person, was distributed in 1982. [16]

Under Section 43.23.005(a) of the Alaska Statutes, an individual qualifies for a Fund dividend if he or she applies to the Department of Revenue and --

1. is a citizen or lawful permanent resident of the United States;

2. is a state resident on the date of application;

3. was a state resident during the entire qualifying year;

4. has been physically present in the state for at least 72 consecutive hours at some time during the two years before the current dividend year;

5. was, at all times during the qualifying year, physically present in the state, or if absent, was absent only as allowed [in this chapter]; and

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[16] *See Permanent Fund Dividend Program, available at* http://www.apfc.org/alaska/dividendprgrm.cfm?s=4.

6. has not been disqualified by reason of felony conviction.

B. Alaska Permanent Fund Corporation ("APFC")

1. Establishment of APFC

The Alaska Constitution does not specify how APF should be managed. When APF was first established, it was managed by the Alaska Commissioner of Revenue. Alaska Stat. § 37.10.065, *repealed by* 1980 Alaska Sess. Laws ch. 18, § 10. In 1980, APFC was created for the purpose of "provid[ing] a mechanism for the management and investment of [APF] assets . . . ." Alaska Stat. § 37.13.030.[17]

The statute established APFC as "a public corporation and government instrumentality in the Department of Revenue managed by the board of trustees." Alaska Stat. § 37.13.040. APFC is treated as a state agency. 1987-1 Op. (Inf.) Att'y Gen. Alas. 473, File No. 66-87-0420 (June 22, 1987); 1982 Op. (Inf.) Att'y Gen. Alas., File No. 366-269-83 (Dec. 2, 1982). As a state agency, APFC is subject to the Alaska Administrative Procedure Act; the Executive Budget Act; statutes regarding public records, public meetings, conflicts of interest, and adoption of regulations; multiple provisions of the Alaska Statutes relating to public officers and employees; and various contracting and procurement requirements applicable to state agencies. *See* 1993 Op. Att'y Gen. Alas., File No. 663-93-0250 (Jan. 26, 1993); Op. Att'y Gen. No. 366-269-83 (citing *ASHA v. Dixon*, 496 P.2d 649 (Alaska 1972)).

APFC is exempt from all state taxes and assessments. Alaska Stat. § 37.13.180. APFC is immune from suit except to the extent that legislation has been enacted into law consenting to suits against the State. Op. Att'y Gen. 366-269-83. APFC uses the same fiscal year as the state.[18] The enabling statute did not specify the term of existence of APFC. Thus, the legislature can abolish APFC at will and transfer its functions back to the Department of Revenue or to another state agency.

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[17] In addition to managing the Fund, APFC has managed the assets of certain other funds designated by law. Alaska Stat. §37.13.050. It is our understanding that the only other fund that APFC is currently managing is a portion of the Alaska mental health trust fund. *See* Alaska Stat. § 37.13.300.

[18] *See* APF 2002 Annual Report, p 32. We also understand, based on discussions with staff of APFC, that APF, APFC and the State of Alaska use the same taxpayer identification number.

2. Board of Trustees

The affairs of APFC are managed by the board of trustees. Alaska Stat. § 37.13.040. Board members of APFC are appointed by the Governor of Alaska. Alaska Stat. § 37.13.050(a). The board consists of six members. *Id.* Two members must be heads of principal departments of state government, one of whom must be the Commissioner of Revenue. *Id.* The other four members are appointed by the Governor from the public and may not hold any other state or federal office, position or employment, except as a member of the armed forces. *Id.* Public members must have recognized competence and wide experience in finance, investments, or other business management-related fields. Alaska Stat. § 37.13.050(b). They are appointed for staggered four-year terms. Alaska Stat. § 37.13.060. The Governor may remove a member of the board. Alaska Stat. § 37.13.070. "A removal . . . must be in writing and must state the [cause] for the removal." *Id.* Four members of the board constitute a quorum for the transaction of business and the exercise of the powers and duties of the board. Alaska Stat. § 37.13.080. Action may be taken only upon affirmative vote of a majority of the full membership of the board. *Id.*

Pursuant to the board's authority to manage the affairs of APFC under Alaska law,[19] on September 12, 1980, the board of trustees adopted bylaws of APFC. The bylaws set forth the rules for internal governance of APFC. The board of trustees may adopt regulations to interpret Title 37, Chapter 13 of the Alaska Statutes (the statutes dealing with APF and APFC). Alaska Stat. § 37.13.205; APFC Bylaws art. III, § 11. In the past, APFC promulgated regulations covering accounting practices.[20] No regulations are currently in effect.[21]

3. Employees

The board employs and determines the salary of an executive director. Alaska Stat. § 37.13.100. The executive director, with the approval of the board, selects and employs additional staff as necessary. *Id.* APFC employees are exempt from the State Personnel Act, which provides standard procedures for classification of positions, a pay plan establishing salaries, recruitment, hiring, evaluation of performance, hearing of grievances, transfer, layoff, termination, hours of work, disciplinary procedures and similar matters. *See* Alaska Stat. §§ 39.25.010-39.25.995; Alaska Stat. § 37.13.100;

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[19] Alaska Stat. § 37.13.040.

[20] *See* former Alaska Admin. Code tit. 15, § 137.060 (effective May 31, 1981, Register 78; repealed July 12, 1992, Register 123).

[21] *See* Alaska Admin. Code tit. 15, ch. 137 (showing all APFC regulations repealed).

Alaska Stat. § 39.25.110 (11)(B); Op. Att'y Gen. No. 366-269-83.[22] Instead, APFC employees are subject to APFC's own position classification plan and salary schedules. The salaries of APFC employees are established by the board based on the recommendation of the compensation committee (consisting of at least three members of the board of trustees of APFC who are appointed by the Chairman of the board. Alaska Stat. § 37.13.100; APFC Bylaws art. II, § 5(a)(2)). However, provisions generally applicable to state employees, such as those related to travel expenses, leaves of absence, insurance and supplemental benefits in lieu of social security, retirement benefits and deferred compensation, apply to APFC employees. Op. Att'y Gen. No. 366-269-83. The trustees and employees of APFC are covered under the state's combined casualty insurance policy, the state's performance bond, and the state's self-insurance risk management plan. *Id.* The trustees and employees of APFC are protected from personal liability to the same extent as other state employees and are entitled to indemnity from the state. *Id.*

Legal advice is provided to APFC by the Alaska Attorney General. Op. Att'y Gen. No. 366-269-83.

4. Operating Budget

The source of APFC's operating budget is the revenue generated by APF's investments. Alaska Stat. § 37.13.150. APFC submits an annual budget to the state legislature pursuant to the Executive Budget Act. Alaska Stat. § 37.13.150; Op. Att'y Gen. No. 366-269-83. APFC's budget is included in the State's operating budget.[23] Pursuant to its budget authorization, APFC pays its expenses out of the revenues generated by the Fund's investments.[24] Salaries and benefits of APFC employees are paid via the State of Alaska payroll system. APFC reimburses the State for the cost of its payroll.[25] Any unused budget authorization lapses and is treated as income of the Fund.[26] *See* Alaska Stat. § 37.13.150. All operating funds of APFC are public funds subject to the constitutional requirement that they be used only for a public purpose, and may not be

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[22] Employees who are exempt from the State Personnel Act are referred to as being in "the exempt service" of the State. *See* Alaska Stat. § 39.25.110. The exempt service contains 38 classes of employees, including investment officers in the Department of Revenue, who are exempt from the State Personnel Act. *See id.*; Alaska Stat. § 39.25.110(26). Employees of the legislature, the court system, the Governor's office, and several boards, commissions and authorities are also exempt.

[23] *See* Alaska Stat. § 37.13.150; Alaska Sess. Laws ch. 83, § 1 (2003) (Department of Revenue).

[24] *See* Alaska Stat. § 37.13.150

[25] Dept. of Revenue/APFC Reimbursable Services Agreement, No. 0430053.

[26] Alaska Stat. § 37.13.150.

expended in a manner inconsistent with the government-approved budget. 1993 Op. Att'y Gen. Alas. No. 663-93-0397 (July 6, 1993).

5. Investment Authority

Investment authority over APF's assets is vested in the board of APFC. The exercise of this authority by the board is subject to the prudent investor rule and the requirement set forth in Article IX, Section 15, of the Alaska Constitution that the principal of APF "be used only for those income-producing investments specifically designated by law. . . ." Alaska Const. art. IX, § 15; Alaska Stat. § 37.13.120(a).

The types of investments that the board may make are restricted by law. Alaska Stat. § 37.13.120(g). The board is required to maintain a reasonable diversification among investments. Alaska Stat. § 37.13.120(c). Generally, APFC may not borrow money or guarantee obligations of others from principal of the APF. Alaska Stat. § 37.13.120(e). With respect to real property investments of the Fund, APFC may, through an entity in which the investment is made, borrow money if the borrowing is without recourse to APFC and APF. *Id.*

The Bank of New York ("BNY") is the Custodian for APF and APFC. All securities are shown on BNY's books as held by the "Alaska Permanent Fund."

Real property investments of APF typically are held by APFC, acting for and on behalf of APF. In each of the documents governing the acquisition, ownership or disposition of APF's real estate investments, APFC is identified as acting for APF, much as an agent is sometimes identified as acting for a principal (*e.g.*, "John Doe, as attorney-in-fact for Jane Smith"). The reason the owner is not simply listed as the "Alaska Permanent Fund" is that the Fund has no clear and separately recognized legal status.

Neither APF nor APFC directly owns any real property assets. In order to insulate the other assets of the Fund (and the State of Alaska generally) from property-related liabilities, and in many cases to provide a vehicle for collective investment by multiple equity investors, all of APF's real property investments are made through separate LLCs, partnerships or corporations that in turn own fee title to the real estate. Investments held solely by APFC are almost always held through separate corporations that have been recognized as tax-exempt by the Internal Revenue Service (the "Service" or the "IRS") under Code Section 501(c)(25). Investments in which other co-investors

also participate are typically held through limited liability companies, although a few older real estate interests are still held by general partnerships or limited partnerships.[27]

6. Accounting and Oversight

The board publishes an annual report for distribution to the Governor, the State legislature and the public. Alaska Stat. § 37.13.170. The report contains audited financial statements, a statement of the amount of money received by the Fund from each investment during the period covered, a list of investments with their fair market values, a description of Fund investment activity, an evaluation of the Fund's performance in light of the goals in Section 37.13.020 of the Alaska Statutes, an evaluation of investment criteria utilized by the board and any other relevant information. Alaska Stat. § 37.13.170. In addition to the annual report, the board is required to submit long-range and quarterly investment reports to the Legislative Budget and Audit Committee. Alaska Stat. § 37.13.120(d). The Legislative Budget and Audit Committee has oversight responsibility over APFC's operations. Alaska Stat. § 37.13.160. Policies for the day-to-day management of APFC, however, are set by the board. Alaska Stat. § 37.13.120.

Meetings of the board are subject to the Alaska Open Meetings Act. 1985 Op. Att'y Gen. Alas. 193, File No. 366-364-85 (Feb. 21, 1985); Op. Att'y Gen. No. 663-93-0397. Alaska statutes regarding public records, conflicts of interest, and adoption of regulations apply to APFC. Op. Att'y Gen. No. 366-269-83. All books and records of APFC, unless confidential, are available for public inspection. Alaska Stat. § 37.13.200; APFC Bylaws, art. IV, § 2.

C. Constitutional Amendments

Amendments to the Alaska Constitution that would require specific disbursements from the Fund are currently under consideration. Specifically, there is under consideration a constitutional amendment that would require payment of the permanent fund dividend to residents of Alaska. Proposals to amend Article IX, section 15 of the Alaska Constitution by incorporating into the Constitution current statutory provisions regarding payment of the permanent fund dividend are currently pending in both the House and the Senate of the Alaska state legislature.[28] It is understood, however, that the objective of these proposals -- placing a requirement to pay the permanent fund dividend in the Constitution -- may ultimately be achieved through different language.

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[27] Memorandum from Donald E. Percival, Heller Ehrman White & McAuliffe, to Alaska Department of Law (Sept. 17, 2003).

[28] *See* Sponsor Substitute for House Jt. Res. 3, 23rd Alaska Legislature (2003); Senate Jt. Res. 19, 23rd Alaska Legislature (2003).

We also have been asked to consider whether an amendment to the Constitution that would dedicate a portion of the Fund's income to public education would have an impact on the federal income tax status of the Fund or the Corporation. It is our understanding that the purpose of this amendment would be to use income from the Fund to defray a portion of the State's obligation to fund public education under Chapter 14.17 of the Alaska Statutes.

II. Law

A. Legal Framework

1. Doctrine of Implied Statutory Immunity for States

The Internal Revenue Code neither expressly imposes a tax on the income of states and their political subdivisions nor expressly exempts such income from tax. As a matter of statutory construction, the Service has long adhered to the position that Congress did not intend to tax the income of states, their political subdivisions, and integral parts of states or their political subdivisions, and the Service has not sought to tax their income, in the absence of an express statutory provision imposing tax.[29] GCM 14407, XIV-1 C.B. 103 (1935), *superseded by* Rev. Rul. 71-131, 1971-1 C.B. 28 (incorporating the rationale of GCM 14407, XIV-1 C.B. 103 (1935)); Rev. Rul. 71-132, 1971-1 C.B. 29 (incorporating the reasoning of GCM 13745, XIII-2 C.B. 67 (1934)); Rev. Rul. 87-2, 1987-1 C.B. 18; *Michigan Educ. Trust v. United States*, 40 F.3d 817 (6th Cir. 1994) (recognizing the continued vitality of the principle expressed in GCM 14407).[30]

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[29] An example of a provision expressly imposing a tax on governmental entities is Section 511(a)(2)(B) of the Code, which imposes an income tax on the unrelated business income of state colleges and universities.

[30] The doctrine of implied statutory tax immunity is to be distinguished from the doctrine of constitutional intergovernmental tax immunity. Although the constitution contains no express limitation on the power of either a state or the federal government to tax the other, early cases concluded that the nature of our government as a federation of states gave rise to an implied doctrine of constitutional intergovernmental tax immunity. *See McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819); *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1870). In subsequent cases, the Court has attempted to define the scope of state constitutional immunity from federal taxation. *See, e.g., Allen v. Regents of the Univ. Sys. of Georgia*, 304 U.S. 439 (1938); *State of New York v. United States*, 326 U.S. 572 (1946). And, in recent years, the Court has narrowed the doctrine considerably. *See South Carolina v. Baker*, 485 U.S. 505 (1988); *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985). While there is probably some state income that cannot be

2. Integral Parts of States

Similarly, the Service takes the position that income earned by an integral part of a state or a political subdivision is not subject to federal income tax. An organization operated without any independent organizational form and controlled by government officers is generally treated as an integral part of a state. *See* Rev. Rul. 87-2, 1987-1 C.B. 18; GCM 39601 (Jan. 25, 1985). If an organization has a separate organizational form, the entity may nevertheless be treated as an integral part of the state. *See* GCM 34164 (July 14, 1969); GCM 39601 (Jan. 25, 1985); Treas. Reg. § 301.7701-1(a)(3). As more fully discussed below, whether a separate entity is treated as an integral part of a state depends upon a number of factors, the most important of which are governmental control and governmental funding.

3. Code Section 115(1)

If the separate form of an entity is not disregarded and the organization is treated as an entity separate from the state, then the income earned by the entity will be subject to tax unless its income is excluded from tax under Code Section 115(1) or another provision of the Code such as Section 501(a). Code Section 115(1) excludes from tax income that (a) is derived from the exercise of any essential governmental function and (b) accrues to a state or political subdivision.

4. Legal Authorities

Because the doctrine of implied statutory tax immunity is a product of the Service's interpretation of the internal revenue laws and its long-standing administrative practice, there are no statutory provisions or regulations relating to this doctrine. The primary sources of authority are the Service's revenue rulings that are published in the Internal Revenue Bulletin. Taxpayers may rely on published revenue rulings and it is the policy of the Service to adhere to its published positions in administering the tax laws and in litigation. *See* IRS Chief Counsel Notice CC-2002-043 (Oct. 17, 2002).[31]

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constitutionally taxed, *e.g.*, tax revenues, the scope of the doctrine of constitutional intergovernmental tax immunity is uncertain. *See South Carolina v. Baker*, 485 U.S. 505; *Michigan Educ. Trust v. United States.*, 40 F.3d 817 (6th Cir. 1994). Because of the uncertain scope of any constitutional immunity, as well as the Service's longstanding reliance on statutory construction rather than constitutional doctrine, we do not think it is necessary or helpful to consider the doctrine of constitutional immunity in this opinion.

[31] IRS Chief Counsel Notice CC-2002-043 was issued in response to negative publicity surrounding the Service's litigating position in *Rauerhorst v. Commissioner*, 119 T.C. 157 (2002), in which the Service took a position that was inconsistent with a

The Service also issues private letter rulings (PLRs) to individual taxpayers seeking guidance on specific transactions; Field Service Advisories (FSAs);[32] and General Counsel Memoranda (GCMs).[33] These documents are available to the public under the Freedom of Information Act but have no precedential value. Code § 6110(k)(3). Despite the absence of technical precedential value, PLRs and the Service's internal documents are useful as an indication of the Service's thinking on specific factual situations. *See, e.g.*, *Rowan Cos. v. United States*, 452 U.S. 247, 262 n.17 (1981) (stating that private letter rulings, while not precedential, are evidence of the Service's position); *ABC Rentals of San Antonio, Inc. v. United States*, 142 F.3d 1200, 1207 (10th Cir. 1998) (stating that private letter rulings, while not authoritative, may be cited "as evidence of administrative interpretation"), *supplemented by*, 77 T.C.M. (CCH) 1229 (7th Cir. 1999); *United States v. Wisconsin Power & Light Co.*, 38 F.3d 329, 335 (1994) (stating that technical advice memoranda may be considered "as evidence of administrative practice"). GCMs are useful because they contain detailed legal analysis on important issues. *See, e.g.*, *Morganbesser v. United States*, 984 F.2d 560, 563 (2d Cir. 1993) (holding that GCMs are "helpful in interpreting the Tax Code when 'faced with an almost total absence of case law'"), *nonacq.*, 1996-1 I.R.B. 6 (1995).

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published Revenue Ruling. The court issued a strong rebuke to the Service for disregarding its own ruling, characterizing its action as an "intolerable" and "capricious application of the law." *Rauerhorst*, 119 T.C. 157 (quoting *Estate of McLendon*, 135 F.3d 1017 (5th Cir. 1998); *Phillips v. Commissioner*, 88 T.C. 529 (1987)). The court held that IRS counsel "may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings." *Rauerhorst*, 119 T.C. 157 (quoting *Phillips v. Commissioner*, 88 T.C. 529 (1987)).

[32] Field Service Advisories are case-specific memoranda issued by the IRS National Office to IRS field agents for the following purposes: (1) to provide guidance as to the interpretation or application of the internal revenue laws; (2) to provide advice concerning the development of factual information that will be necessary to determine the proper application of the law to the facts of a particular case; or (3) to provide an assessment of litigating hazards or strategies. *See* Internal Revenue Manual § 35.2.7.4.1 (amended 7-24-1996) ("IRM").

[33] General Counsel Memoranda are formal written legal opinions prepared by a division of the IRS Chief Counsel's Office on substantive and procedural tax issues within its jurisdiction. A GCM contains the analysis and conclusion of the Chief Counsel division preparing the legal opinion on the particular issues and facts addressed at the time of issuance and is to be subsequently utilized as an important research source by Chief Counsel personnel. IRM § 30.7.2.2 (amended 3-26-1985).

B. Doctrine of Implied Statutory Immunity

1. Income of a State vs. Income of an Integral Part of a State

As noted above, both income derived directly by a state and income derived by an integral part of a state are exempt from tax under the doctrine of implied statutory immunity. In theory, if income is earned directly by a state, then it is not taxed and no further analysis is necessary. If income is not earned directly by a state, then a determination must be made as to whether the income has been earned by a separate independent entity or by an integral part of the state. In practice, however, when funds are dedicated to a specific purpose and set aside on a state's books, the Service frequently analyzes the federal tax issues in terms of whether such funds are an integral part of a state and not in terms of whether they are a direct activity of a state.

For example, in PLR 8216088 (Jan. 22, 1982), at issue was a retirement trust fund ("Retirement Fund") created to provide retirement benefits to public school employees of the state. Retirement Fund consisted of several separate accounts held by the state treasury to be used for the benefit of members of the state's public employees' retirement system. Retirement Fund was governed by a board which the relevant statute characterized as an independent administrative board of the state. The statute provided for appropriations for operating expenses of the board from the state treasury. The state treasurer was the custodian of Retirement Fund and all payments from Retirement Fund were made by the state treasurer in accordance with requisitions signed by the secretary of the board and ratified by resolution of the board. Despite the fact that Retirement Fund consisted only of accounts in the state treasury, the Service ruled that both the board and Retirement Fund were integral parts of the state.

In PLR 199722029 (Feb. 28, 1997), the Service characterized a bank account belonging to a governmental entity as an integral part of the entity rather than simply an asset of the entity. PLR 199722029 dealt with a fund created to provide a means of equalizing telephone rates charged to customers of smaller telecommunications companies in a state ("Equalization Fund"). Equalization Fund was created by the state's public utility commission ("PUC"), itself an integral part of the state, and funded through a surcharge on the end-users of telephone services. Equalization Fund was referred to in PUC proceedings as a "program." PUC had the right to terminate Equalization Fund. Equalization Fund and the income therefrom were the property of PUC. PUC delegated the administration of Equalization Fund, including the investment authority over Equalization Fund, to Y, a private provider of telecommunications services in the state. Y functioned as an agent of PUC. To fulfill its duties, Y placed Equalization Fund in a separate bank account to avoid any possible commingling of Equalization Fund with the property of Y. PUC retained the powers of control and supervision over Equalization Fund and the bank account. PUC retained the right to terminate Y's appointment as

administrator of Equalization Fund and the authority to approve or disapprove the persons selected by Y to manage Equalization Fund. By a written order of PUC, Y was obligated to make regular reports to PUC with respect to Equalization Fund. PUC determined the amounts and recipients of disbursements from Equalization Fund's balance in the bank account according to PUC's own guidelines. The Service found that Equalization Fund was not a legal person for purposes of state law and that the bank account was similar to a segregated asset account or sinking fund that PUC had set aside to achieve the purpose of Equalization Fund. Despite PUC's legal ownership of the assets of Equalization Fund and Equalization Fund's lack of standing as a separate legal entity, the Service ruled that Equalization Fund was an integral part of PUC rather than simply property of PUC. *See also* PLR 199840032 (July 1, 1998).

2. Integral Part of a State

a. Rev. Rul. 87-2

The only published ruling on the integral part test is Revenue Ruling 87-2, 1987-1 C.B. 18. In that ruling, the Supreme Court of State A established a trust fund (" Lawyer's Trust Fund") to receive and invest interest on client funds held by lawyers. In concluding that Lawyer's Trust Fund was not an independent entity but was an integral part of the state government, the Service cited the following factors.

i. Supreme Court Control over Governance of Trust

Lawyer's Trust Fund was governed by six lawyers and three public members. Three of the lawyers and the public members were appointed directly by the State Supreme Court. Although the state bar association nominated three of the lawyers, the Supreme Court was not bound to appoint the lawyers from the nominees. The Supreme Court had the power to remove any or all of the governors with or without cause and exercised an active supervisory role over Lawyer's Trust Fund.

ii. Reports to Supreme Court

One of the Supreme Court judges attended each meeting of Lawyer's Trust Fund's governors and reported to the State Supreme Court on Lawyer's Trust Fund. Lawyer's Trust Fund was required to maintain adequate books and records and to make formal quarterly reports to the Supreme Court.

iii. Disbursement of Funds for Public Purpose

The monies in Lawyer's Trust Fund were disbursed by Lawyer's Trust Fund's governors for public purposes as determined by the governors of Lawyer's Trust Fund.

The Supreme Court had the right to override the governors' decisions regarding distributions. The Supreme Court had the right to abolish Lawyer's Trust Fund by court order. In that event, any balance then on hand would be transferred, at the Court's discretion, either to another state agency, an organization described in Section 501(c)(3) of the Code, or State A's general fund.

b. Other Authorities

The Service has issued hundreds of private letter rulings, General Counsel Memoranda and other guidance which, as noted above, do not have the precedential effect of a published Revenue Ruling. These authorities are not always entirely consistent with one another and typically do not contain detailed analyses. Consequently, they engender some confusion as to what factors are determinative of integral part status. Nevertheless, to the extent that the Service consistently cites the same factors in its analyses on the integral part test, the rulings are an indication of the Service's current approach to the integral part test.

i. Critical Factors

In general, the determination of whether an enterprise is an integral part of the state is based on all the facts and circumstances of the case, but with particular emphasis placed upon two factors: (a) the state's degree of control over the enterprise; and (b) the state's financial commitment to the enterprise. *See, e.g.*, PLR 199809013 (Nov. 7, 1997); FSA 001794 (Apr. 29, 1996).[34] In evaluating these two factors, the Service may examine: (1) the extent of the state's involvement in the enterprise's administration and activities; (2) the use of state employees, acting in their governmental capacities, to conduct the business of the enterprise; (3) the extent of the state's control over the

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[34] The two factors that are critical in the Service's integral part analysis, state control and state financial commitment, have different origins. The state control requirement is derived from Revenue Ruling 87-2, which is discussed above. The state financial commitment requirement is derived from the decision in *Maryland Savings-Share Insurance Corp. v. United States*, 308 F. Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970). At issue in *Maryland Savings-Share Insurance Corp.* was the entity's qualification under Section 115 of the Code rather than under the integral part test. Despite the fact that the requirement of state financial commitment was developed in the context of Section 115 analysis, the Service began applying this requirement under the integral part test. There are no published rulings that define the integral part test as the product of state control and state financial commitment. In numerous private letter rulings and FSAs, however, including the two rulings cited above, the Service identified state control and state financial commitment as the critical factors in its integral part analysis.

disbursement of the proceeds or earnings of the enterprise; (4) the extent of the state's control over the assets of the enterprise upon dissolution of the enterprise; and (5) the extent of the state's financial commitment to the enterprise. FSA 001794 (Apr. 29, 1996).

ii. State Control

State control over an enterprise has been shown where:

- The document creating the enterprise provides that the enterprise was intended to be an integral part of the state. PLR 200243040 (July 29, 2002).
- The enterprise is established by a special statute or by an executive order of the governor of the state rather than under the general corporation law. PLR 199923029 (Mar. 11, 1999); PLR 199852018 (Sept. 25, 1998); PLR 200307065 (Nov. 5, 2002).
- The enterprise is placed under a department of a state. PLR 199627016 (Apr. 5, 1996).
- The governing board of the enterprise is made up of government officials or persons appointed or nominated by government officials. GCM 39601 (Jan. 25, 1985); PLR 199627016 (Apr. 5, 1996); PLR 200116017 (Jan. 12, 2001); PLR 199923029 (Mar. 11, 1999).
- Persons serving on the governing board of the enterprise can be removed by officials of a state or political subdivision or agency. GCM 39601 (Jan. 25, 1985); PLR 199722029 (Feb. 28, 1997).
- The duties of the governing board of the enterprise are set forth in a state statute. PLR 200243040 (July 29, 2002).
- The powers and duties of the enterprise are prescribed by statute. PLR 200116017 (Jan. 12, 2001); PLR 199923029 (Mar. 11, 1999).
- Meetings of the board of the entity are public. PLR 199706006 (Nov. 8, 1996); PLR 200222007 (Feb. 20, 2002).
- The enterprise has no employees and is staffed by employees of the state or employees of a political subdivision, agency or agent of the state. GCM 39601 (Jan. 25, 1985); PLR 199722029 (Feb. 28, 1997); PLR 199627016 (Apr. 5, 1996); PLR 200243040 (July 29, 2002); PLR 199952073 (Sept. 27, 1999).
- The legislature sets the salaries of the entity's employees. PLR 200126032 (Sept. 14, 2000).
- The salaries paid to the employees of the enterprise are comparable to the salaries paid to other state employees. PLR 200126032 (Sept. 14, 2000).
- The state or its political subdivision or agency controls the amounts and recipients of disbursements from the enterprise. Rev. Rul. 87-2, 1987-2 C.B. 18; GCM 39601 (Jan. 25, 1985); PLR 199722029 (Feb. 28, 1997).

- The state or its political subdivision or agency determines the ultimate disposition of the assets of the enterprise. Rev. Rul. 87-2, 1987-2 C.B. 18; PLR 199923029 (Mar. 11, 1999).
- The state or its political subdivision or agency supervises the management of the enterprise. PLR 200243040 (July 29, 2002).
- The enterprise reports periodically to state officials or the state legislature. Rev. Rul. 87-2, 1987-2 C.B. 18; GCM 39601 (Jan. 25, 1985); PLR 199627016 (Apr. 5, 1996).
- The enterprise is subject to periodic audits by the state, its political subdivision or agency. PLR 200116017 (Jan. 12, 2001); PLR 199923029 (Mar. 11, 1999).
- The enterprise and/or its board members are subject to state statutes governing other governmental entities of the state. PLR 200243040 (July 29, 2002); PLR 199923029 (Mar. 11, 1999).
- The enterprise has no capacity to sue and be sued in its own name. *See* PLR 199722029 (Feb. 28, 1997).
- The state or its political subdivision or agency has the authority to terminate the enterprise. Rev. Rul. 87-2, 1987-2 C.B. 18; PLR 199923029 (Mar. 11, 1999).
- The state or its political subdivision or agency has control over the daily operations of the enterprise by its power to fund the operations of the enterprise. PLR 200031045 (May 9, 2000).
- The enterprise's financial results are consolidated into the financial statements of the state or its political subdivision or agency. PLR 199952073 (Sept. 27, 1999).

Not all of these factors need to be present for an enterprise to be considered an integral part of a state. Moreover, none of these factors by itself is dispositive. For example, in GCM 39315 (Dec. 21, 1984), the fact that the entity was empowered to sue and be sued in its own name was not considered inconsistent with integral part status. In GCM 39315, the Service did not need to determine whether the entity was an integral part of the government because the entity's income would have been excluded from tax either under the integral part test or under Code Section 115. It is significant, however, that the Service clearly thought that the entity could qualify as an integral part of the state even though it could sue and be sued in its own name. Similarly, in PLR 200126032 (Sept. 14, 2000), not all of the entity's employees were treated as state employees. Notwithstanding that fact, the Service determined from the balance of the factors that the entity was an integral part of the state.

iii. Separate Organizational Structures: Importance of Law of Formation

An important factor relevant to the determination of state control is whether the corporation was formed under general state law relating to corporations or under a special

statute. In GCM 34164, the Service suggested that this factor is dispositive on the issue of state control. Specifically, the Service stated that "whenever a corporation is formed under general state law it will be a corporation in the technical sense of the word since it must comply with the same requirements imposed upon all other corporations formed under the same statute. As such, the corporation will be . . . subject to Federal income tax regardless of the fact that it may be wholly-owned by a state or one of its political subdivisions."[35] Notwithstanding the forthright statement in GCM 34164, in a number of rulings, the Service has treated an entity as an integral part of the state even though the entity was organized under the state's general corporation statutes rather than by a special act of the state legislature. *See, e.g.*, PLR 200031045 (May 9, 2000) (ruling that the entity qualified as an integral part of the state even though the entity was incorporated under the state's general nonprofit corporation law); PLR 199952073 (Sept. 27, 1999) (same).

iv. State's Financial Commitment

Historically, the degree of state control was the primary factor for determining whether an enterprise qualified as an integral part of a state. In recent years, the Service has added to the integral part analysis the requirement of financial commitment from the state or political subdivision. As a result, the Service is likely to deny integral part status to an entity that derives its funds primarily from private sources. *See, e.g.*, PLR 199906036 (Oct. 13, 1998). In PLR 199906036, the State A legislature created Association to provide windstorm and hail damage insurance for Area. Every insurer authorized to do business in State A was required to be a member of Association. One of Association's statutory purposes was to protect policyholders of Association and to reduce the potential for payments by members of Association in the event of losses. To fulfill this statutory purpose, Association and Department, a department of State A, created Insurance Fund. Insurance Fund, which was not incorporated under state law, was separate and distinct from the State A treasury, and was funded by contributions from members of Association. Insurance Fund was administered by State A employees pursuant to an agreement between Association and the state. The administration of Insurance Fund was subject to oversight by Department. State A did not make any direct or indirect cash contribution to Insurance Fund. The Service ruled that, although Insurance Fund satisfied the control portion of the test for integral part status, it did not satisfy the state financial commitment portion of the test.

Substantial financial commitment to an enterprise by a state has been shown where:

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[35] In GCM 34164, the Service noted that a corporation that would not be considered an integral part of a state or political subdivision might nevertheless be exempt from tax under Section 501(a) or 115(1).

- The state or its political subdivision or agency has legal ownership of the assets of the enterprise. PLR 199722029 (Feb. 28, 1997); PLR 200116017 (Jan. 12, 2001).
- The state has appropriated funds for the use of the enterprise. PLR 199923029 (Mar. 11, 1999).
- The state or its political subdivision or agency has transferred property to the enterprise. PLR 200031045 (May 9, 2000).
- The state has pledged its full faith and credit for debt obligations used to support the enterprise. PLR 199627016 (Apr. 5, 1996).
- Unexpended funds of the enterprise revert to the state or its political subdivision or agency. PLR 200243040 (July 29, 2002).
- The state or its political subdivision or agency pays the wages of the state employees administering the enterprise. PLR 200243040 (July 29, 2002).
- The enterprise does not reimburse the state for services provided to it by state employees. PLR 199952073 (Sept. 27, 1999).
- The enterprise receives revenues under a contract with a state or its political subdivision or agency. PLR 199923029 (Mar. 11, 1999).
- The state is entitled to the profits generated by the entity. PLR 199909013 (Nov. 25, 1998).
- Upon dissolution, all assets of the enterprise pass to the state, its political subdivision or agency. PLR 200116017 (Jan. 12, 2001).

Not all of these factors need to be present to satisfy the state financial commitment requirement. For example, in PLR 199722029 (Feb. 28, 1997), the requirement of state financial commitment was held to be met because the assets of the enterprise were owned by an integral part of the state, even though the enterprise was funded by surcharges on private individuals rather than by contributions from the state.

v. Public Purpose and Private Benefit

As discussed above, the determination of whether an enterprise qualifies as an integral part of a state generally turns on two principal factors: state control and state financial commitment. The Service's rulings in this area do not generally address the issue of whether an enterprise serves a public purpose or provides a private benefit. None of the rulings we reviewed expressly stated that an enterprise must serve a public purpose in order to be treated as an integral part of a state. In several rulings the Service made statements to the effect that the particular enterprises under consideration served a public purpose, but did not discuss the meaning of the term. For example, in Revenue Ruling 87-2, the Service noted that the income of Lawyer's Trust Fund was "disbursed . . . for public purposes" but did not specify what "public purposes" Lawyer's Trust Fund served. In PLR 200222007 (Feb. 20, 2002), the Service described a fund as having been established "for the public purpose of insuring the existence of an orderly market [of

certain types of insurance] for State residents and businesses." The Service did not explain why the purpose so described was public rather than private.

In several rulings, the Service cited the lack of public purpose or the presence of private benefit as a negative factor in the analysis of an entity's integral part status. *See* PLR 199733003 (May 9, 1997); PLR 199347001 (July 26, 1993). In these rulings, however, the lack of public purpose or the presence of private benefit was not the sole ground for denying the entity's integral part status, and the determination of the integral part status ultimately turned on the two critical factors -- state control and state financial commitment. In PLR 199733003 (May 9, 1997), the state sued operators of a trade school for various violations of state law. The case settled and the state deposited the settlement proceeds into Fund A to be used as restitution to students who had enrolled in the trade school. Fund A was maintained and accounted for by the attorney general as the receiver for the money paid into the fund. Disbursements from Fund A were made pursuant to court order. The Service ruled that Fund A was not an integral part of the state because the state lacked a sufficient financial commitment to Fund A. Almost as an afterthought, the Service observed that Fund A was distinguishable from Lawyers Trust Fund in Revenue Ruling 87-2 because the income and principal of Fund A benefited private parties and lacked the public benefit of Lawyers Trust Fund. In PLR 199347001 (July 26, 1993), X was a joint underwriting association of private insurers established by state statute. X was governed by a board some of whose members were elected by the insurers and others of which were appointed by an elected official of the state. The purpose of X was to provide insurance to otherwise uninsurable private entrepreneurs. X was funded primarily by policy premiums. The Service ruled that X was not an integral part of the state because X received no state funds and no funds from X were applied to any public purposes. Again, the lack of public purpose was not the sole ground for denying the integral part status. We are not aware of any ruling in which an enterprise that was funded entirely by the state was held to lack a public purpose.

There are many rulings in which payments were made to or on behalf of private persons and yet the entities making such payments were held to be integral parts of a state. For example, in PLR 200243040 (July 29, 2002), a trust fund was established to provide medical benefits for retired state employees ("Medical Fund"). The assets of Medical Fund were credited to separate recordkeeping accounts established for each participant. Individual participants could direct the investment of the amounts credited to their accounts among different investment options. Disbursements from Medical Fund were used to pay participants' post-retirement medical expenses. The state controlled Medical Fund and made a significant financial commitment to Medical Fund. Without raising the private benefit/public purpose issue, the Service ruled that Medical Fund was an integral part of the state. *See also* PLR 200210024 (Nov. 29, 2001) (program to reimburse cancer-stricken active and retired firefighters for certain medical expenses

qualified as an integral part of the state); PLR 8216088 (Jan. 22, 1982) (fund to provide retirement benefits to public school employees qualified as an integral part).

In PLR 199840032 (July 1, 1998), a fund ("Reimbursement Fund") was established by the public utility commission ("PUC"), an integral part of the state, for the purpose of reimbursing telecommunications providers who provided discounted service to qualifying schools, libraries, hospitals, health clinics and community-based organizations. Reimbursement Fund was funded by surcharges on end-users of telecom services. Reimbursement Fund was managed by a committee appointed and controlled by PUC. PUC determined the amounts and recipients of disbursements from Reimbursement Fund. The Service ruled that Reimbursement Fund was an integral part of PUC and did not address whether Reimbursement Fund served a public purpose. *See also* PLR 8931042 (May 8, 1989) (fund established to subsidize the utility rates of the poor held to be an integral part).

In PLR 200222007 (Feb. 20, 2002), a fund ("Disaster Fund") was established by the state legislature "for the public purpose of insuring the existence of an orderly market of [certain types of insurance] for State residents and businesses." Disaster Fund paid insureds' claims when losses occurred. Finding that the state control and the state financial commitment requirements were satisfied, the Service ruled that Disaster Fund was an integral part of the state. Except for the conclusory statement that Disaster Fund was established for a specific public purpose, the public purpose requirement was not discussed. *See also* PLR 9507037 (Nov. 21, 1994) (Florida state disaster fund, organized to reimburse private insurers for a percentage of losses from a natural disaster, was an integral part of the state because the fund was controlled by state officials and the state had a financial interest in the fund), *supplemented by*, PLR 9522039 (Mar. 6, 1995) (amendments to the enabling statute enacted after the issuance of the initial ruling would not adversely affect the initial ruling); PLR 9706006 (Nov. 8, 1996) (California state disaster fund, established to provide disaster insurance coverage to private persons, was an integral part of the state because the fund was controlled by state officials and the state made a substantial financial commitment to the fund).

In sum, although the public purpose language appears in a number of rulings, there is no specific requirement that an entity must serve a public purpose in order to qualify as an integral part of a state. Likewise, there is no specific prohibition against private benefit; and in fact, in a number of rulings, entities that made distributions to private individuals were held to be integral parts of a state and the issue of private benefit was not even raised.

3. Return Requirement

States, political subdivisions and integral parts of states and political subdivisions are not required to file federal income tax returns. *See* Rev. Rul. 78-316, 1978-2 C.B. 304.

C. Section 115 Exclusion from Gross Income

Section 115(1) excludes from tax income (a) derived by a separate entity[36] from the exercise of any essential governmental function and (b) accruing to a state or political subdivision.

1. Essential Governmental Function

The Service takes the position that investment of state funds is an essential governmental function. *See* Rev. Rul. 77-261, 1977-2 C.B. 45. In Rev. Rul. 77-261, the state treasurer of State X established Investment Fund under State X law for the purpose of investing funds of State X and its political subdivisions. The establishment of Investment Fund was authorized by state statute. Investment Fund was established under a written declaration of trust and designated as an instrumentality of State X. Investment Fund was managed by the state treasurer as trustee. The income of Investment Fund was allocated among and accrued to State X and its political subdivisions. The Service ruled 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." 1977-2 C.B. at 46. Accordingly, Investment Fund's income was held to derive from the performance of an essential governmental function.

2. Accrual

It is the position of the Service that income accrues to a state or political subdivision for purposes of Code Section 115 where the state or political subdivision has an unrestricted right to receive its proportionate share of such income as that income is earned. *See* Rev. Rul. 77-261, 1977-2 C.B. 45, *as clarified by* Rev. Rul. 78-316, 1978-2 C.B. 304. In Rev. Rul. 77-261, described above, State X authorized establishment of an investment fund for the purpose of investing funds of State X and its political subdivisions. The treasurer of State X as trustee of the fund sold participation units in the

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[36] Section 115 and its predecessors have been interpreted to apply only to separate entities that do not qualify as integral parts of a state. *See* GCM 37657 (Aug. 31, 1978); GCM 14407, XIV-1 C.B. 103 (1935).

fund to State X and its political subdivisions. The income of the fund was allocated among and accrued to State X and its political subdivisions in proportion to the number of units held by each participant. Each participant was entitled to withdraw any amount from its account in the fund at any time. The Service ruled that, since the participating political subdivisions and State X had an unrestricted right to receive their proportionate share of the fund's income as it was earned, the fund's income accrued to them within the meaning of Code Section 115.

The Service's view of the accrual requirement is more lenient than the view espoused by the courts. Older judicial decisions had required actual receipt of the income. *See Bear Gulch Water Co. v. Commissioner*, 116 F.2d 975 (9th Cir.), *cert. denied*, 314 U.S. 652 (1941). Other judicial decisions, particularly more recent ones, have held that the receipt of the income may either be actual or constructive. *See City of Bethel v. United States*, 594 F.2d 1301 (9th Cir.), *cert. denied*, 444 U.S. 980 (1979); *Omaha Pub. Power Dist. v. O'Malley*, 232 F.2d 805 (8th Cir.), *cert. denied*, 352 U.S. 837 (1956).

3. Private Benefit

Section 115 does not contain an express prohibition against private benefit. In recent years, however, the Service has taken the position that Code Section 115 will not apply if the operation of the enterprise involves more than an incidental private benefit. For example, in Rev. Rul. 90-74, 1990-2 C.B. 34, the Service considered the application of Code Section 115 to the income of certain risk-sharing pools operated on behalf of state and local governments. The entity was formed, operated, and funded by various political subdivisions to pool their casualty risks or other risks arising from their obligations concerning public liability, workers' compensation, or employees' health. Revenue Ruling 90-74 held that the income of such risk-sharing pools was excluded from gross income under Code Section 115 only if private interests neither participated in the entity nor benefited more than incidentally from the entity. The payments to covered workers were considered an incidental benefit to them.

4. Return Requirement

Corporations are required to file annual federal income tax returns on Form 1120 even if their income is excluded under Code Section 115(1). Code § 6012(a); Rev. Rul. 77-261, 1977-2 C.B. 45; PLR 8728057 (Apr. 15, 1987).

III. Analysis

A. The Fund

1. The Fund as Currently Constituted Should Not Be Subject to Federal Income Tax Because It Is Operated Directly by the State.

Several factors support the position that income earned by the Fund is income earned directly by the State of Alaska and not by an integral part of the state. However, as noted above, the Service rarely distinguishes one from the other.

a. The Fund Has no Legal Existence Separate From the State.

The Fund was created by an amendment to the Alaska Constitution but has no separate organizational structure. It is no more than a collection of assets or investments that are owned directly by the State. The Fund's assets and income are included in the State's financial statements. The Fund was not created as a trust or a corporation by statute or any type of organizing document, and it has neither trustees nor a governing board. Although the legislative history of the Fund and the Corporation's annual reports refer to the Fund as a "trust," the Alaska Constitution and the Alaska Statutes pertinent to the Fund do not use the words "corporation" or "trust" in relation to the Fund. The Fund is clearly not a trust in the legal sense of the word.[37]

The principal and the income of the Fund are included in the financial statements of the State of Alaska and are considered by Moody's and Standard & Poor's in rating the State's bonds. The Fund is treated as inseparable from the state for liability purposes; *i.e.*, the Fund is immune from suit, except to the extent the government of the State of Alaska has consented to be sued. The Fund is exempt from all state taxes and assessments. Alaska Stat. § 37.13.180. The Fund's annual reports refer to the Fund as an "investment savings account that belongs to the State of Alaska." *See* APF 2002 Annual Report.

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[37] The term "trust" is defined in Treasury regulations for tax purposes as an arrangement whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Treas. Reg. § 301.7701-4(a).

b. The Fund's Principal Is Derived From Natural Resources That Are the Property of the State.

Article IX, Section 15 of the Alaska Constitution provides that "[a]t least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments." The courts have held that Alaska's natural resources and the earnings generated thereby belong to the State of Alaska. *Beattie v. United States*, 635 F. Supp. 481, 491 (D. Alaska 1986), *aff'd*, *Greisen v. United States*, 831 F.2d 916, 918 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988). In creating the Fund, the State did not renounce or disclaim its proprietary interest in the assets placed in the Fund. The Alaska Attorney General's office has issued an opinion advising that the assets of the Fund are owned by the State of Alaska. 1983 Op. Att'y Gen. Alas. 112, File No. 366-656-83 (Aug. 10, 1983).

c. Income Earned From Investment of the Fund's Principal Is Disbursed as Provided by State Law.

The Constitution requires "[a]ll income from the permanent fund [to] be deposited in the general fund unless otherwise provided by law." Alaska Const. art. IX, § 15. Thus, the Constitution envisions a perpetual cycle in which the Fund derives its principal from the revenues of the State and then adds earnings from the investment of the Fund's principal back to the revenues of the State, to be disbursed as provided under state law. From 1977-1979, the earnings of the Fund were in fact deposited in the general fund. Under currently applicable provisions of Alaska law, the earnings of the Fund are deposited in the earnings reserve account from which transfers are made to the principal of the Fund to offset the effect of inflation and to the Dividend Fund to make disbursements to residents of the State.[38] Alaska Stat. § 37.13.145(b), (c). In *Beattie*, the court held that the earnings of the Fund were subject to the requirement of the Alaska Constitution that state funds can be expended only for public purposes, thus implicitly holding that the earnings of the Fund are state funds. 635 F. Supp. at 483.

d. The State has Absolute Control Over the Fund

As befits the owner of property, the State of Alaska has complete control over the Fund. When the Fund was first established, the Alaska Department of Revenue managed the Fund. In 1980, APFC was established by state statute to manage the Fund. However,

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[38] The earnings in the earnings reserve account may be appropriated by the state legislature in the same manner as amounts in the general fund. *See Cowper*, 874 P.2d 922.

transfer of the management of the Fund to APFC does not diminish the State's absolute control over the Fund. Just as APFC was created by statute, it can be terminated by statute.

e. Summary

In summary, the lack of any organizational structure separate from the State, the State's ownership of the Fund's assets and its income, and the State's control of the Fund's administration and disbursements all point to the conclusion that the Fund is an asset owned by the State and its income is income earned directly by the State. In our opinion, income earned by APF is income earned directly by the State from its property. Thus, under the doctrine of implied statutory tax immunity, the Fund should not be subject to federal income tax. *See* GCM 14407, XIV-1 C.B. 103 (1935); Rev. Rul. 71-131 1971 C.B. 28; Rev. Rul. 71-132, 1971 C.B. 29. Because income earned by APF is income earned directly by the State, APF should not be required to file a federal income tax return.

2. In the Alternative, the Fund as Currently Constituted Should Not be Subject to Federal Income Tax Because It is an Integral Part of the State.

As discussed above, the Service tends to analyze cases in terms of whether an enterprise is an integral part of a state, even when it appears that the enterprise could be considered operated directly by the state. Thus, it is possible that the Service may contend that the establishment of the Fund by constitutional amendment as a segregated permanent fund, managed by a separate corporation, sets it apart from the State sufficiently for the integral part analysis to be necessary. In our opinion, the Fund should be held to meet the requirements for treatment as an integral part of a state.

a. APF Has the Same Characteristics as the Fund in Revenue Ruling 87-2.

As noted above, Revenue Ruling 87-2 is the only published ruling on the integral part test. APF and Lawyer's Trust Fund in Revenue Ruling 87-2 are strikingly similar. Because Lawyer's Trust Fund in Revenue Ruling 87-2 was held to be an integral part of the state, APF should also be treated as an integral part of the State. [39]

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[39] As mentioned above, it is the policy of the Service to follow its own published guidance. IRS Chief Counsel Notice CC-2002-043 (Oct. 17, 2002).

i. Establishment of the Fund.

In Revenue Ruling 87-2, the state Supreme Court, a branch of the state government, established Lawyer's Trust Fund. APF was established by a constitutional amendment to the Alaska Constitution. The amendment was passed by a two-thirds vote of each house of the legislature, a branch of state government, and approved by majority vote of the people of Alaska. Alaska Const. art. XIII, § 1.

ii. Governance of the Fund.

In Revenue Ruling 87-2, the state Supreme Court had control over the appointment and removal of the nine members of the governing board of Lawyer's Trust Fund. APF itself does not have a governing board. However, the governor appoints and has the power to remove members of the board of trustees of APFC, which was created by state statute to manage the Fund. There is no meaningful distinction between Revenue Ruling 87-2 and Alaska's situation with reference to fund governance.

iii. Reporting Requirements.

In Revenue Ruling 87-2, a Supreme Court judge attended all meetings of the governing board and reported to the court on the meeting. In addition, Lawyer's Trust Fund submitted quarterly reports to the Supreme Court. Again, APF has no existence separate from the State but APFC reports to the governor, the state legislature and the public. Specifically, APFC publishes an annual report for distribution to the Governor, the State legislature and the public and quarterly reports for submission to the Legislative Budget and Audit Committee. The Legislative Budget and Audit Committee has oversight responsibility for the activities of APFC. Meetings of the board of APFC are open to the public. All books and records of APFC, unless privileged, are available for public inspection.

iv. Disbursement of Funds.

In Revenue Ruling 87-2, amounts were disbursed from Lawyer's Trust Fund for public purposes and the Supreme Court had ultimate control over those disbursements. As funds of the State, the income of APF must, under the Alaska Constitution, be disbursed for public purposes. Moreover, because the Constitution provides that income from the Fund is to be deposited in the general fund of Alaska unless otherwise provided by law, the State of Alaska controls the disbursement of funds through the legislative process. As noted above, the legislature has exercised this power by passing statutes to protect the value of the Fund from erosion through inflation and to make disbursements to residents through the Dividend Fund.

v. Termination of the Fund.

In Revenue Ruling 87-2, Lawyer's Trust Fund could be terminated by the court and any balance remaining would then be transferred to another state agency, an organization exempt under Section 501(c)(3), or the general fund of the state. APF was established by constitutional amendment and can be terminated by constitutional amendment. Because APF is an asset of the State of Alaska, under the Alaska Constitution, if APF is dissolved, its funds must be used for public purposes.

b. Other Authorities

APF also should be held to satisfy the two critical factors that are applied in the Service's interpretations of the integral part test -- state control and state financial commitment.

i. State Control

As discussed above, the State's degree of control over the Fund is absolute. The Fund does not have a separate legal identity and cannot sue and be sued in its own name. *See* PLR 199722029 (Feb. 28, 1997). The Fund does not have its own trustees or employees. *See* GCM 39601 (Jan. 25, 1985); PLR 199722029 (Feb. 28, 1997). The State is solely responsible for the disposition of income from the Fund. *See* Rev. Rul. 87-2, 1987-2 C.B. 18; PLR 199923029 (Mar. 11, 1999). The Fund's assets are reflected in the financial statements of the State. *See* PLR 199952073 (Sept. 27, 1999).

The Fund is managed by APFC, which was created by the State and can be dissolved by the State. APFC is located within the State's Department of Revenue. *See* PLR 199627016 (Apr. 5, 1996). APFC is treated as a State agency and is subject to State statutes applicable to governmental agencies. *See* PLR 199923029 (Mar. 11, 1999). APFC reports periodically to the Governor of the State and the State legislature. *See* Rev. Rul. 87-2, 1987-2 C.B. 18.

The Trustees of APFC are appointed by the Governor. GCM 39601 (Jan. 25, 1985); PLR 199627016 (Apr. 5, 1996). Two of the trustees of APFC are high-ranking State officials. *See* PLR 199627016 (Apr. 5, 1996). The trustees of APFC can be removed by the Governor of the State. *See* GCM 39601 (Jan. 25, 1985); PLR 199722029 (Feb. 28, 1997). The duties of the trustees are prescribed by statute. *See* PLR 200243040 (July 29, 2002).

The employees of APFC who are responsible for the day-to-day administration of the Fund are State employees. *See* Rev. Rul. 87-2, 1987-2 C.B. 18; GCM 39601 (Jan. 25,

1985); PLR 199722029 (Feb. 28, 1997); PLR 200243040 (July 29, 2002); PLR 199627016 (Apr. 5, 1996).

These factors in combination make a compelling case that the state control requirement is met.

ii. State Financial Commitment

The principal of the Fund is funded entirely by the State's mineral revenues, special appropriations by the State legislature, and the income from investment of the Fund's principal. There are no requirements for any private contributions. The operating costs of APFC, which is the manager of APF, are paid out of the income of the Fund, pursuant to a budget that is approved under the provisions of the Executive Budget Act that governs the budgetary appropriations of all State agencies.

iii. Public Purpose and Private Benefit

As discussed above, there is no specific requirement that integral parts of a state serve a public purpose. Likewise, there is no specific prohibition against private benefit. In any event, APF serves a public purpose and does not provide a private benefit. Although a portion of the income of APF is used to pay dividends to the residents of Alaska, the payment of dividends should not be deemed to constitute a private benefit. Under the Constitution of Alaska, the income of the Fund can be expended only for public purposes. *See Beattie*, 635 F. Supp. at 483. The payment of dividends is made pursuant to state law, in accordance with the public purposes stated therein. Specifically, the Dividend Fund program has the following public purposes: (1) to provide equitable distribution of a portion of the State's energy wealth to Alaskans; (2) to encourage people to remain Alaska residents, thereby reducing population turnover in the state; and (3) to encourage awareness and interest in the management of the Fund. 1980 Alaska Sess. Laws ch. 21, § 1(b). Thus, as in Revenue Ruling 87-2, the Fund's distributions, including the dividends, are made for public purposes, as provided by State law.

The Fund resembles those entities that disburse medical or retirement benefits to private persons or to entities that ensure the availability of certain services to private persons. As discussed above, numerous rulings treat such entities as integral parts of a state. *See, e.g.*, PLR 200243040 (July 29, 2002); PLR 200210024 (Nov. 29, 2001); PLR 8216088 (Jan. 22, 1982); PLR 8931042 (May 8, 1989); PLR 200222007 (Feb. 20, 2002); PLR 200140032 (July 3, 2001). Like those entities, the Fund satisfies the key requirements under the integral part test -- state control and state financial commitment -- and thus, like those entities, the Fund should be treated as an integral part of the State even if it is assumed that payments of Fund dividends constitute a private benefit.

It should not be assumed that Fund dividends constitute a private benefit, however, because the Fund's dividend program benefits on equal statutory terms virtually all residents of the State. In PLR 200140032 (July 3, 2001), the Service ruled that a fund that provided incentives for the use of renewable energy sources by state residents was an integral part of the state, and noted with approval that that fund was used for programs that benefited equally the entire populace of the state. *See also* PLR 199522039 (Mar. 6, 1995) (in ruling that the California state disaster fund qualified as an integral part of the state, noted with approval that the programs of the fund were open to all citizens of the state). In sum, the Fund should be viewed as serving a public purpose and should not be deemed to provide a private benefit.

c. Summary

If the income of the Fund is not treated as income earned directly by the State, then the Fund should be treated as an integral part of the State and its income should not be subject to federal income taxation under the authority of GCM 14407 and Revenue Ruling 87-2. As an integral part of the State of Alaska, the Fund should not be required to file a federal income tax return.

B. The Corporation

1. APFC Should Not Be Subject to Federal Income Tax Because It Is an Integral Part of the State.

We understand that APFC manages APF but has no income of its own.[40] Its operating expenses are paid out of the revenue generated by the Fund's investments pursuant to a budget that is submitted to the legislature and approved by the legislature under the procedures established by the Executive Budget Act. Alaska Stat. § 37.13.150. Thus, from the standpoint of tax liability, the issue of whether APFC is exempt from federal income tax is not particularly important.[41] The significant issue is whether APFC

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[40] As noted above APFC also manages a portion of the Alaska mental health trust fund. APFC is reimbursed for expenses incurred in the management of the mental health trust. *See* Alaska Stat. § 37.14.009(a)(3); Alaska Stat § 37.14.041(a)(4)(A). It is our understanding that APFC does not make a profit or accumulate funds from this management function.

[41] If APFC were taxable, arguably, it would have no gross income and thus no tax liability. Alternatively, the payment of APFC's expenses by the State (*i.e.*, out of the revenue of APF, an asset of the State) might be treated as gross income to APFC for federal income tax purposes. In that case, APFC's gross income (which would equal its expenses) presumably would be offset by deductible expenses. Because of the complexity of the tax laws, it is possible that some portion of APFC's expenses would

must file a federal income tax return. An integral part of a state is not required to file a return, while a separate corporate entity that is not treated as an integral part of a state is required to file a return, even if it has no gross income or tax liability. Code § 6012(a)(2); Rev. Rul. 78-316, 1978-1 C.B. 259.

a. State Control

Much of the discussion above regarding whether the Fund would be considered an integral part of the State relies on the fact that the State controls and funds the corporation that manages the Fund, and is equally germane to the question whether the corporation itself would be considered an integral part of the State. As noted above, APFC was created by state statute and can be terminated at any time. Moreover, it is a part of the Department of Revenue, and is treated as a State agency. In addition, the Governor's control over appointments to the board of APFC, and the fact that employees of APFC are employees of the State are indicative of State control over APFC. Further, the fact that the operating budget of APFC is subject to the Executive Budget Act and that budgeted amounts are paid out of the Fund's income demonstrate that the State is the sole source of funding for APFC.

The significant difference between the Fund and APFC is that APFC was formed as a "public corporation" and a "government instrumentality" while APF has no separate legal identity. On these facts, it must be determined whether the Corporation is so "subservient" to the State that its corporate form should be ignored and it should be treated as an integral part of the State.

The fact that APFC was created by a special statute rather than under general State laws governing corporations indicates that APFC is an integral part of the State. *See* GCM 34164 (July 14, 1969). APFC does not possess a regular corporate form and is not subject to the general corporate laws of the State of Alaska. *Cf.* GCM 34164 (July 14, 1969). APFC's organizational attributes, duties and obligations are prescribed in its enabling statute. *See* PLR 200116017 (Jan. 12, 2001). APFC is located within the Department of Revenue and is treated as a State agency subject to State statutes governing other governmental entities. *See* PLR 199627016 (Apr. 5, 1996); PLR 200243040 (July 29, 2002).

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not be deductible and that gross income would not be entirely offset by deductible expenses. However, it is likely that gross income would be entirely, or almost entirely, offset by deductible expenses. Moreover, as discussed below, if APFC does not qualify as an integral part of the State of Alaska, its income should be excluded from gross income under Code Section 115(1).

Furthermore, the board of APFC is controlled by the State. All six members of APFC's board of trustees are appointed by the Governor of Alaska and are subject to removal by the Governor. *See* GCM 39601 (Jan. 25, 1985); PLR 199627016 (Apr. 5, 1996); PLR 199722029 (Feb. 28, 1997). Two members of APFC's board are high-ranking public officials.

Another important factor is that APFC's employees, who are responsible for its day-to-day operations, are State employees. *See* Rev. Rul. 87-2, 1987-2 C.B. 18; GCM 39601 (Jan. 25, 1985); PLR 199627016 (Apr. 5, 1996); PLR 199722029 (Feb. 28, 1997). In a number of rulings, operational control of an entity by state employees acting as such versus operational control by private parties was a critical factor in deciding whether an entity was an integral part of a state. *See* GCM 39601 (citing to GCM 39006 (Apr. 28, 1983); GCM 34535 (June 28, 1971); GCM 38921 (July 29, 1982)). As noted above, employees of APFC are exempt from the State Personnel Act and their salaries are established by the board of APFC, but they are nonetheless State employees.

Furthermore, the State controls APFC's expenditure of operating funds through the budget process and APFC is empowered to make expenditures only for the purposes specified in its enabling statute. The Governor, the legislature and the public are kept informed of APFC's activities and performance through formal and informal reports. *See* Rev. Rul. 87-2, 1987-2 C.B. 18; PLR 9627017 (Apr. 5, 1996). Meetings of the board are open to the public.

These factors strongly point to the conclusion that APFC meets the state control requirement for purposes of the integral part test.

b. State Financial Commitment

APFC has no independent funding and is entirely dependent upon the State for its operating funds. Its operating budget must be approved by the State legislature and is paid from the earnings of the Fund, which is State property. *See* GCM 38921 (Nov. 26, 1982); Rev. Rul. 87-2 1987-2 C.B. 18; PLR 199923029 (Mar. 11, 1999). No private individuals or entities either invest money in APF or APFC or have a property interest in the assets of either. *See Geisen v. United States*, 831 F.2d 916, 918 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988). Unused budget authorizations of APFC cannot be accumulated by APFC but rather lapse and are treated as income of the Fund. *See* PLR 200243040 (July 29, 2002). Because the State funds the operations of APFC, the State has made a financial commitment to APFC for integral part test purposes.

c. Summary

In our opinion APFC should be treated as an integral part of the State because it was formed under a special statute rather than the general corporation law, the State of Alaska exercises control over APFC through the appointment of its board and detailed statutory provisions regarding its operations, and it is funded entirely by State appropriations pursuant to the Executive Budget Act. Its income, if any, should be excluded from federal income tax under the authority of GCM 14407 and Revenue Ruling 87-2, and it should not be required to file income tax returns.

2. APFC's Income, if Any, Should Be Excludable Under Section 115(1) of the Code

In the unlikely event that APFC is not treated as an integral part of the State, the income of APFC, if any, should be excluded from gross income under Section 115(1) of the Code because (a) APFC is exercising an essential governmental function; and (b) the income of APFC, if any, accrues to the State of Alaska. Because APFC's activities are limited to managing and investing the assets of APF and other funds, all of which are assets of the State, APFC's activities should not raise any private benefit issues.

a. Essential Governmental Function

The purpose of APFC is to manage and invest the property of the Fund. Based on the Service's holding in Revenue Ruling 77-261 that investment of state funds is an essential governmental function, APFC should be treated as performing an essential governmental function.[42] Although the investments at issue in Revenue Ruling 77-261 were short-term investments and limited to high-grade money market instruments, the reasoning in Revenue Ruling 77-261 did not turn on the type of investments. Thus, the proposition that investment of state funds is an essential governmental function should hold true regardless of the type of investments involved or the term of the investments.

b. Accrual

As discussed above, APFC does not have any source of income. However, the State's payment of APFC's operating expenses might be treated as a reimbursement of expenses that is includable in gross income for federal income tax purposes. *See, e.g.*, PLR 200332025 (Jan. 7, 2003) (ruling that reimbursement of operating expenses of an entity providing telecommunications services to the poor was income under Section 61 of

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[42] As noted above, APFC manages other funds designated by law. It is our understanding, based on discussions with staff in the Law Department, that all funds managed by APFC are property of the State of Alaska.

the Code). If the State's payment of APFC's operating expenses out of revenues from the Fund gives rise to gross income for federal tax purposes, all such income should be treated as accruing to the State of Alaska because it may be used solely for the benefit of the State, *i.e.,* to manage APF, an asset owned by the State. Furthermore, because any budget appropriation that is not expended, lapses and is added to the income of APF, APFC does not accumulate any income.

c. Return Requirement

If the income of APFC is excluded from gross income under Code Section 115 rather than under the integral part doctrine, APFC would be required to file a corporate income tax return.

C. Impact of Constitutional Amendments on Federal Income Tax Treatment of the Fund and Corporation

As noted above, amendments to the Alaska Constitution that would require payment of a dividend to residents of Alaska from the Fund, commonly referred to as a permanent fund dividend, are under consideration. Although proposed constitutional amendments regarding the permanent fund dividend are pending in the House and Senate of the Alaska legislature, our opinion is not based on the specific language of the pending amendments and is not limited to the amendments that are currently pending. We have also been asked to consider the effect of a constitutional amendment that would require that a portion of the Fund's earnings be used to defray the State's obligations to fund public education. No specific constitutional amendments have been introduced in the legislature regarding dedication of earnings from APF to public education.

A constitutional amendment requiring payment of a dividend from the APF would not in any way affect the Corporation. APFC would continue an existence under the present statutory scheme. Such an amendment also would not affect the Fund's status if it were regarded as operated directly by the State (as we believe it should be). Because the Service has consistently concluded that Congress did not intend to tax the states, if a determination is made that the Fund is operated directly by the State, that is the end of the federal government's inquiry.

Nor should a constitutional amendment requiring payment of a permanent fund dividend change the answer to the question whether the Fund is an integral part of the State. If the Fund were viewed as sufficiently separate from the State to be subject to the integral part test, it would then be necessary to determine whether the constitutional amendment would affect the critical factors discussed above -- state control and state financial commitment. A constitutional amendment requiring payment of a permanent

fund dividend would not change the source of the Fund's revenue, and thus the state financial commitment test should be held to be satisfied.

The state control test likewise should be held to be satisfied. Under current law, the State of Alaska controls the Fund through the constitutional provision establishing the Fund and through various statutory provisions. The incorporation into the State Constitution of a requirement to pay a permanent fund dividend or the addition of provisions to the State Constitution that provide for disbursements for public education from the Fund should not affect the State's control over the Fund. The fact that the State Constitution is higher in the hierarchy of State law and subject to different procedures than a state statute for passage and amendment does not change the fact that the constitution is the law of the State. *See Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 176-77 (1803) (holding that the federal Constitution is the supreme law of the land). Further, it does not change the substance and effect of the provisions at issue for purposes of federal income tax law. If the provisions that would be incorporated into the Alaska Constitution under the proposed amendments would not cause the Fund to be taxable when included in State statutes, they should not cause the Fund to be taxable when included in the State Constitution.

The requirement that a constitutional amendment be ratified by the voters of Alaska does not diminish State control over the Fund or result in private control over the Fund. In framing or amending a constitution, the people act in their collective capacity as a body politic rather than as private individuals. The act of the people framing or amending a constitution is an act of lawmaking as much as an act of a state legislature passing a statute is an act of lawmaking. *See* Robert F. Williams, *State Constitutional Law Processes*, 24 Wm. & Mary L. Rev. 169, 175-77 (1983). The only difference between them is that an act of voter-approved lawmaking is an expression of direct democracy while an act of legislative lawmaking is an expression of representative democracy. Although constitutional law ranks higher than statutory law, both of these bodies of law are closely intertwined in many states because many constitutional provisions are not self-executing and require implementing legislation. *See* Robert F. Williams, *The Brennan Lecture: Interpreting State Constitutions as Unique Legal Documents*, 27 Okla. City U.L. 189, 222 (Spring 2002); G. Alan Tarr, *Understanding State Constitutions* 22-23 (1998).

In our opinion, because a state constitution is a form of state law, the adoption of a constitutional amendment requiring payment of a permanent fund dividend should have no effect on the federal income tax status of the Fund. In other words, any provision that would not affect the federal income tax status of the Fund if included in the Alaska Statutes would not affect the status of the Fund merely because the provision was incorporated into the Constitution.

Similarly, the adoption of a constitutional amendment requiring that a portion of earnings from the Fund be used to defray the State's obligation to fund public schools should have no effect on the federal income tax status of the Corporation or the Fund, as long as the substance of the amendment does not affect the Fund's ability to satisfy the integral part test.

We note, however, that our opinion on the impact of constitutional amendments that would require payment of a permanent fund dividend and dedication of a portion of the Fund's earnings to public education is based on general concepts and not on any specific proposed amendment.

IV. Conclusion

We conclude that APF, as currently constituted, should not be subject to federal income tax because it is an asset of the State of Alaska and its income is earned directly by the State of Alaska or, in the alternative, because it is an integral part of the State of Alaska. As an asset of the State or an integral part of the State, APF should not be required to file federal income tax returns. In our opinion, the adoption of a constitutional amendment requiring payment of a permanent fund dividend or an amendment requiring that a portion of earnings from the Fund be used to defray the State's obligations to fund public education should not affect the qualification of APF as property and income of the State of Alaska or as an integral part of the State of Alaska.

We further conclude that APFC, as currently constituted, should not be subject to federal income tax because it is an integral part of the State of Alaska. As an integral part of the State, APFC should not be required to file federal income tax returns. In the alternative, APFC's income should be excluded under Section 115 of the Code. However, if the income of APFC is excluded by reason of Section 115, rather than by reason of APFC's integral part status, APFC would be required to file corporate federal income tax returns. In our opinion, the adoption of a constitutional amendment requiring payment of a permanent fund dividend or an amendment requiring that a portion of earnings from the Fund be used to defray the State's obligations to fund public education should not affect the qualification of APFC as an integral part of the State or the application of Section 115 to APFC.

Sincerely,

STEPTOE & JOHNSON LLP