



PETER B. BRAUTIGAM
JEFFREY F. DAVIS
COLE M. LINDEMANN
ROBERT L. MANLEY
JANE E. SAUER
CHARLES F. SCHUETZE
OF COUNSEL
F. STEVEN MAHONEY

ATTORNEYS AT LAW - A PROFESSIONAL CORPORATION

March 24, 2014 **Via E-mail**

Alaska State Legislature
Legislative Budget & Audit Committee
State Capitol, Room 514
Juneau, Alaska 99801

Re: Whether the Alaska Gasline Development Corporation's Interest in the Gas Project Contemplated by the Memorandum of Understanding, Heads of Agreement, and SB 138 and HB 277 Would Be Exempt from Federal Taxation
Our File No. 12463-01

Ladies and Gentlemen:

The Legislative Budget & Audit Committee of the Alaska State Legislature has requested advice about the tax implications and antitrust issues associated with the Governor of Alaska's gas pipeline and liquefied natural gas proposal. This letter addresses the tax exemption implications of the proposal, and revises and expands on the letter of March 23, 2014. The antitrust implications of the proposal are addressed in the March 23, 2014 letter of Baker & Miller PLLC.

We have been asked to review: the December 12, 2013 Memorandum of Understanding among the State of Alaska ("State"), Trans-Canada Alaska Company, LLC, Foothills Pipe Lines Ltd., Trans-Canada Alaska Development Inc. ("Trans-Canada"); the January 14, 2014 Heads of Agreement among the State, the Alaska Gasline Development Corporation ("AGDC"), Trans-Canada, ExxonMobil Alaska Production Inc., ConocoPhillips Alaska, Inc. and BP Exploration (Alaska) Inc., and the pending enabling legislation, originally submitted as Senate Bill 138 and House Bill 277.

The Memorandum of Understanding, the Heads of Agreement, and the current versions of Senate Bill 138 and House Bill 277 contemplate that the State would take an equity interest in part or all of an Alaska liquefied natural gas project, including design, development, construction and operation of the infrastructure and services required to

transport, liquefy, ship and market natural gas and associated hydrocarbons, specifically including a Prudhoe Bay unit gas transmission line, a Point Thomson unit gas transmission line, a gas pipeline, a gas treatment plant, a liquefied natural gas plant, and a marine terminal (the "Project"), and involving State ownership of, or participation in, up to 25% of the Project (the "Interest"). (As would be provided in AS 31.25.005(5) and AS 31.25.390(7) (Sec. 2 of CS for Senate Bill No. 138 (FIN) am)).

The purpose of the Project includes developing natural gas pipelines, to deliver natural gas in-state for the maximum benefit of the people of Alaska, to provide economic benefits and revenue to the State, and to maximize royalty and tax revenues from Alaska natural gas. (As would be provided in AS 31.25.005 (Sec. 1 of CS for Senate Bill No. 138 (FIN) am)).

The State's Interest in the Project would be held by AGDC,

a public corporation and government instrumentality acting in the best interest of the state for the purposes required by AS 31.25.005, located for administrative purposes in the Department of Commerce, Community, and Economic Development, but having a legal existence independent of and separate from the state.

(As would be modified in AS 31.25.010 (Sec. 2 of CS for Senate Bill No. 138(FIN) am)).

AGDC is governed by a board of directors consisting of five public members, appointed by, and serving at the pleasure of, the governor and subject to confirmation by the legislature and two individuals designated by the governor that are each the head of a principal department of the State. AS 31.25.020. The AGDC board shall appoint a program director and executive director for the Project. AS 31.25.040(d) and 31.25.045. The personnel of AGDC are exempt from AS 39.25, the State Personnel Act. AS 31.25.065.

AGDC has been granted the power of eminent domain, exercisable by filing a declaration of taking under AS 09.55.240 - 09.55.460, to acquire land or an interest in land that is necessary for the Project; the exercise of powers by AGDC may not exceed the permissible exercise of the powers by the State. AS 31.25.080(a)(4), as would be modified in Sec. 4 of CS for Senate Bill No. 138 (FIN) am.

The board of AGDC has been granted the power to "adopt regulations to carry out the purposes of [AS 31.25]". AS 31.25.130(c). AGDC is generally required to post proposed regulations for public comment at least 15 days prior to adoption. AS 31.25.130(d). Regulations adopted by AGDC's board shall be made available to members of the public and to the chair of the Administrative Regulation Review Committee under AS 24.20.400-24.20.460. AS 31.25.130(a).

AGDC has been given access by statute to the information of departments, agencies, and public corporations of the State that is directly related to the planning, financing, development, acquisition, maintenance, construction, or operation of the Project. All departments, agencies, and public corporations of the State are required to cooperate with, and provide information, services, and facilities to AGDC, and are generally required to give priority to processing authorization applications and other requests of AGDC. Further, the Department of Natural Resources is generally required to grant AGDC a right-of-way lease under AS 38.35 for the Project's gas pipeline transportation corridor at no appraisal or rental cost. AS 31.25.090.

The revisions proposed in SB 138 and HB 277 to AS 31.25.110 would authorize a Project fund, established in AGDC and consisting of money appropriated to it. AGDC would be responsible for fund management, but may contract with the Department of Revenue for fund management. If money were appropriated to the fund to finance the cost of the Project, AGDC would create an account in the fund for that purpose and hold the money appropriated for that purpose in that account. AGDC may use money appropriated to the fund without further appropriation for the purpose of managing the fund, for purposes related to the Project, and for purposes of transferring net revenue received to an appropriate fund as determined by the commissioner of revenue in consultation with the commissioner of natural resources.

AGDC has the power to form subsidiary corporations to develop, construct, operate, and finance in-state natural gas pipeline projects or other transportation mechanisms, although this power does not seem to cover owning an interest in a gas liquification plant and/or marine terminal, powers which seem to be reserved to AGDC itself. AS 31.25.120.

I. Whether AGDC Qualifies as a Political Subdivision of the State of Alaska.

If AGDC qualifies as a political subdivision of the State of Alaska for tax purposes, its income would not be subject to federal taxation, under the doctrine of implied statutory immunity.

Income earned by a state, a political subdivision of a state, . . . is generally not taxable in the absence of specific statutory authorization for taxing such income.

Rev. Rul. 87-2 (emphasis added).

The income of states and their political subdivisions is exempt from federal taxation because, with one exception,¹ the Internal Revenue Code does not expressly impose a tax on them. States and their political subdivisions are protected by implied statutory immunity, implied from the failure of the Internal Revenue Code to either expressly subject them to, or exempt them from, federal income taxation.² *E.g.*, Rev. Rul. 87-2; *Estate of Alexander J. Shamberg*, 3 T.C. 131, 146 (1944), *acq.*, 1945 C.B. 6, *aff'd*, 144 F.2d 998 (2d Cir. 1944), 1945 C.B. 335, *cert. denied*, 323 U.S. 792 (1944).

A political subdivision is a division of the state which has been delegated the right to exercise part of the powers of a sovereign. *Id.* To determine whether AGDC qualifies as a political subdivision of the State, and under implied statutory immunity is not subject to federal income taxation, the IRS applies the Treasury regulations interpreting § 103 of the Internal Revenue Code. Rev. Rul 77-164; see also GCM 36,994 (Feb. 3, 1977). Under Treas. Reg. § 1.103-1(b), a “political subdivision” refers to “any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.” Sovereign powers include the power to tax, the power of eminent domain, and the police power. Rev. Rul. 77-164; *Estate of Shamberg*.

The first case to analyze the sovereign powers that a state or local subdivision must have to establish implied statutory immunity from federal taxation was the *Estate of Shamberg*, which concerned the Port of New York Authority (“Port Authority”). *Estate of Shamberg* is particularly important, as the structure of the Port Authority resembles in key respects the structure of AGDC. Specifically, the Port Authority was

endowed with the power of eminent domain, and with certain police powers, including the promulgation and enforcement of regulations for the conduct of navigation and commerce in the area defined as the Port of New York District.

Estate of Shamberg, 3 T.C. at 143.

AGDC likewise has the same two of the three sovereign powers, namely the power of eminent domain and certain police powers. First, AS 31.25.080(a)(4) provides that

¹ Namely, IRC § 511(a)(2)(B) imposes the unrelated business income tax on state colleges and universities.

² Implied statutory immunity is different from the constitutional doctrine of intergovernmental tax immunity, which formerly provided substantial protection to states and their political subdivisions from federal taxation. However, the Supreme Court of the United States has in recent decades held that states and their political subdivisions have no broad constitutional protection from federal taxation. *E.g.*, *New York v. United States*, 326 U.S. 572 (1946), and *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985).

AGDC has the power of eminent domain. Second, AGDC has significant police powers—AS 31.25.130(c) provides that the board of AGDC “may adopt regulations to carry out the purposes of [AS 31.25]”).

AGDC’s power under AS 31.25.130(c) to “adopt regulations to carry out the purposes of [AS 31.25]” is an example of a police power, one of the sovereign powers that can qualify AGDC as a political subdivision (and correspondingly exempt it from taxation). The police power

embraces regulations designed to promote the public convenience or the general prosperity, as well as regulations designed to promote the public health, the public morals or the public safety.

Philadelphia Nat’l Bank v. U.S., 666 F.2d 834, 840 (3d Cir. 1981), *cert. denied*, 457 U.S. 1105, 73 L. Ed. 2d 1314, 102 S. Ct. 2904 (1982) (quoting *Chicago, Burlington & Quincy Ry. Co. v. Illinois ex rel Drainage Comm’rs*, 200 U.S. 561, 592 (1906)).

Estate of Shamberg found that the Port Authority’s police powers included “the promulgation and enforcement of regulations for the conduct of navigation and commerce in the area defined as the Port of New York District.” As discussed above, AS 31.25.130(c) authorizes AGDC to “adopt regulations to carry out the purposes of [AS 31.25]” Further, AS 31.25 authorizes AGDC to build and own an interest in feeder and transmission natural gas pipelines, and a related LNG plant and marine terminal. In sum, the regulatory power under AS 31.25.130(c) is similar to the regulatory power held by the Port Authority at issue in *Estate of Shamberg* .

All three sovereign powers need not be delegated for AGDC to qualify as a political subdivision for purposes of § 103. Rev. Rul. 77-164, citing *Estate of Shamberg*, states that:

Three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the police power It is not necessary that all three of these powers be delegated. However, possession of only an insubstantial amount of any or all sovereign powers is not sufficient.”

(Emphasis added.)

IRS private letter rulings routinely grant political subdivision status to entities that have only one of the three sovereign powers, such as a library district with the power of taxation, a school district with the power of eminent domain, or a health care authority with the power of eminent domain. Ellen P. Aprill, *The Integral, the Essential, and the*

Instrumental: Federal Income Tax Treatment of Governmental Affiliates, 23 *Iowa J. Corp. L.* 803, 808-9 (1998).

If AGDC intends to qualify for federal tax exemption under implied statutory immunity, it is essential that AGDC retain substantial police (i.e., regulatory) powers under AS 31.25.130(c), in addition to the power of eminent domain. General Counsel Memorandum 37,771 noted that:

Whatever doubt exists as to exactly what constitutes the minimum amount of required "sovereign power" this Office is unprepared to concede that the possession of only one sovereign power is sufficient. We arrive at this conclusion after considering that the enumerated sovereign powers (taxation, eminent domain, police) can exist in an entity in only a minor degree and recognizing that all the facts and circumstances must be taken into consideration, including the public purposes of the entity and control of the entity by a government.

(Citing *Gen. Couns. Mem.* 36,994, at 7-8.]

Revenue Ruling 73-563 held that a rapid transit authority qualified as a political subdivision under Treas. Reg. 1.103-1 for purposes of issuing tax-exempt bonds because the authority, in part because it had the police power to set rates, determine routes, and enforce its regulations by maintaining a security force, but also because the state legislature empowered participating state governing bodies to levy retail and use taxes to fund the authority and authorized them to exercise the power of eminent domain on behalf of the authority. Likewise, SB 138 and HB 277, together with the statutes they modify, provide that certain State agencies are required by statute to assist AGDC by exercising certain police powers on behalf of AGDC, providing additional evidence that AGDC should qualify as a political subdivision.

Further, AS 31.25.090(a) provides AGDC with access to information of State departments, agencies, and public corporations directly related to the planning, financing, development, acquisition, maintenance, construction, or operation of the Project. All State departments, agencies, and public corporations are required by AS 31.25.090(a) to cooperate with, and provide information, services, and facilities to AGDC, and are generally required to give priority to processing authorization applications and other requests of AGDC. Finally, AS 31.25.090(d) generally requires the Department of Natural Resources to grant AGDC a right-of-way lease under AS 38.35 for the Project's gas pipeline transportation corridor at no appraisal or rental cost.

If AGDC intends to qualify for implied statutory immunity, it will need to address language in AS 31.25 that suggests that AGDC is not a political subdivision of the State. First, AS 31.25.240 states that obligations issued under AS 31.25 are not debts of "the

state or of a political subdivision of the state,”³ implying that AGDC is not a political subdivision. Second, AS 31.25.010 states that AGDC is an instrumentality of the State. As discussed below in the section on instrumentalities, an “instrumentality” for federal tax purposes is by definition something other than a state or a political subdivision of the state. In order to qualify for tax exemption under implied statutory immunity, AGDC will need to prove that it is, in fact, a political subdivision of the State regardless of the language in AS 31.25.010, and is not an instrumentality for federal tax purposes. Specifically, AS 31.25.010 provides that AGDC is

a public corporation and government instrumentality acting in the best interest of the state for the purposes required by AS 31.25.005, located for administrative purposes in the Department of Commerce, Community and Economic Development, but having a legal and existence independent of and separate from the state.

AS 31.25.010, as would be modified in Sec. 2 of CS for Senate Bill No. 138(FIN) am (emphasis added).

Treasury Regulation § 301.7701-1(a)(3) provides that an entity that is separate from a state or political subdivision “is not always recognized as a separate entity for federal tax purposes.”⁴ For instance, the Second Circuit held in *Estate of Shamberg* that the Port Authority of New York qualified as a political subdivision, even though the Port Authority’s authorizing statutes provided, similar to AS 31.25.010 describing AGDC as a “public corporation and instrumentality,” that the Port Authority is

a body politic and corporate⁵ created by a compact made between the States of New York, [**5] Laws N.Y. 1921, c. 154, and New Jersey on April 30, 1921, N.J.S.A. 32:1-1 et seq., and approved by Congress on August 23, 1921, 42 Stat. 174.

Estate of Shamberg at 1000 (emphasis added). See also Rev. Rul. 70-562 (finding that a county board of education, described as an instrumentality of the state, qualified as a political subdivision—an acceptable charitable donee under § 170(b)(1)(A)).

³ Note that AS 31.25.240 does not say that obligations issued under AS 31.25 are not debts of “the state or of another political subdivision of the state,” etc.

⁴ Adding, by way of example, that “an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.”

⁵ AGDC is similarly described as a “body corporate and public” in AS 31.25.260(b), dealing with the tax exempt status of its bonds.

In order to clarify that AGDC qualifies for federal tax exemption under implied statutory immunity, the State is advised to consider revising SB 138 and HB 277 to provide that AGDC is a political subdivision, at least for purposes of its eminent domain and police (i.e., regulatory) powers, as well as for tax exemption purposes, and also consider revising language in AS 31.25.240 and AS 31.25.010 suggesting that it is not a political subdivision.

Further, the State is strongly recommended to secure a private letter ruling confirming that AGDC qualifies for tax exemption under implied statutory immunity as a political subdivision of the State.

II. Whether AGDC is an Integral Part of the State.

If AGDC did not qualify for exemption from federal taxation as a political subdivision of the State, the question would then be whether AGDC qualifies for tax exemption as an integral part of the State or a political subdivision of the State.

Alaska Statutes 31.25.010 provides that AGDC is a:

public corporation and government instrumentality acting in the best interest of the state for the purposes required by AS 31.25.005, located for administrative purposes in the Department of Commerce, Community, and Economic Development, but having a legal existence independent of and separate from the state.

(Emphasis added.)

This corporate separation raises the issue whether AGDC would be treated as a taxable corporation under federal law, separate from the State of Alaska, which is not subject to federal taxation. A corporation is generally treated as separate from its shareholders for tax purposes. *Moline Props., Inc. v. Comm'r*, 319 U.S. 436, 438-439 (1943).

Whether AGDC qualifies as an integral part of the State turns on whether its corporate status would prevent AGDC from being treated as an integral part of the State for tax purposes.

Over the years, the IRS has extended the income tax exemption it provides to states and political subdivisions to entities it regards as their "integral parts." See Rev. Rul. 87-2, 1987-1 C.B. 18; see also Treas. Reg. § 301.7701-1(a)(3).

IRS Announcement 2011-78, n. 24, 2011-51 I.R.B. 874 (12/19/2011) (emphasis added).

Revenue Ruling 87-2 provides that:

Income earned by . . . an integral part of a state or political subdivision of a state is generally not taxable in the absence of specific statutory authorization for taxing such income.

(Emphasis added). In other words, even if AGDC failed to have any sovereign power qualifying it as a political subdivision of the State, AGDC could still be exempt from federal income tax if it is an integral part of the State or one of its political subdivisions.

Although AS 31.25.010 states that AGDC is a corporation “having a legal existence independent of and separate from the state,” Treas. Reg. § 301.7701-1(a)(3) provides that AGDC’s corporate status should not prevent AGDC from being treated as an integral part of the State for tax purposes:

an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.

Treasury Regulation § 301.7701-1(a)(3) indicates that the corporate separation of AGDC can be ignored for tax purposes if AGDC is an integral part of the State. The accompanying regulation, Treas. Reg. § 301.7701-2(b)(1) & (6), seems to say that a corporation such as AGDC will, if it is not an integral part of the State, be taxed as a separate corporation.

For federal tax purposes, the term corporation means—(1) A business entity organized under a Federal or State statute, . . . if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; (6) A business entity wholly owned by a State or any political subdivision thereof . . .

Id.

Unfortunately Treas. Regs. § 301.7701-1 & -2 provide no guidance regarding the circumstances that will cause a corporation wholly owned by a state or a political subdivision to be considered an integral part of the state. The Tax Court recently addressed whether a corporation organized under Delaware law was, analogous to Treas. Reg. § 301.7701-1(a)(3), an integral part of an Indian tribe and thus not exempt from federal taxation. *Uniband Inc. v. Comm’r*, 140 TC 13 (2013). The Tax Court in *Uniband* ultimately found that Uniband was organized as a state law business corporation and not under tribal law, that Uniband’s constituent documents did not guarantee tribal control of Uniband, that Uniband appeared to have financial autonomy from the tribe, and held that Uniband was not an integral part of the tribe and was subject to federal taxation.

Private letter rulings addressing whether a corporation formed by a state, like AGDC, qualifies for federal tax exemption as an integral part of the state⁶ look to whether (a) there is sufficient state control over the entity and (b) whether the state has made a financial commitment to fund the corporation.

The State would control AGDC by controlling its board of directors, consisting of members appointed by, and serving at the pleasure of, the governor and subject to confirmation by the legislature and individuals designated by the governor that are each the head of a principal department of the State. AS 31.25.020.

The State would be making a substantial financial commitment to fund AGDC, and would be controlling its finances. First, as noted immediately above, the State would maintain board control of AGDC. AS 31.25.020. Second, the revised AS 31.25.110 provides that AGDC could only transfer revenues that it has received to an appropriate fund as determined by the commissioner of revenue in consultation with the commissioner of natural resources.

Recent private letter rulings holding that an enterprise or organization qualifies as an integral part of the state for tax purposes use the same analysis and cite substantially the same authorities, regardless whether the enterprise or organization was formed as a corporation. Namely, they each cite⁷ Rev. Rul. 87-2 as establishing that income earned by an enterprise that is controlled by the state and is an integral part of the state is not generally subject to federal taxation, and cite *Maryland Savings-Share Insurance Corp. v. United States*, 308 F.Supp. 761, *rev'd on other grounds*, 400 U.S. 4 (1970), for the proposition that, in order to qualify as an integral part of the state, the state must have made a sufficient financial commitment to the enterprise as well as maintained sufficient state control over the enterprise.⁸

⁶ A private letter ruling is only binding on the taxpayer(s) who requested the ruling; they are nonetheless a useful indication of how the IRS would rule on a specific transaction. The only published ruling in this area, Rev. Rul. 87-2, concerned a lawyer trust account fund created by order of the state supreme court that was not an independent entity. Taxpayers are entitled to rely on revenue rulings (such as Rev. Rul. 87-2), which are an official interpretations of the tax law on specific transactions published by the national office of the Internal Revenue Service.

⁷ Of the private letter rulings discussed immediately below, PLR 200403026 and 200427016 also cite Treas. Reg § 301.7701-1(a) as providing that an organization wholly owned by a state is not recognized as a separate entity for federal tax purposes if it is an integral part of the state.

⁸ Each of the private letter rulings listed immediately below also distinguishes *Michigan v. United States*, 802 F. Supp. 120, 127 (W.D. Mich. 1992), *rev'd*, 40 F. 3d 817 (6th Cir. 1994), which the Service believes is a flawed opinion that misapplied Rev. Rul. 57-128. (Professor Aprill also criticizes the *Michigan* opinion, concluding that "[i]n treating the trust as exempt, the majority confused and misapplied the tests for political subdivision, instrumentality, and integral part." 23 *Iowa J. Corp. L.* at 825.) While the *Michigan*

For instance, PLR 200403026 held that a hospital was as an integral part of a city for federal income tax purposes. The ruling found that the city had substantial control over the hospital (all of the members of the board were appointed by the mayor and subject to approval of the city commissioners; and the hospital's annual budget and audit were reviewed annually by the city commission). The ruling found that the city had made a substantial financial commitment to the hospital (the city contributed the hospital facilities and the land on which the facilities are located; and the city contributed cash and bond proceeds, including the proceeds from general obligation bonds, for the acquisition of additional land and the construction and renovation of the hospital facilities).

PLR 200136011 held that an authority, created by state statute to encourage commercial space flight from the state by promoting research and participating in the development of a commercial flight center, was as an integral part of the state for federal income tax purposes. The ruling found that the state had substantial control over the authority (of the authority's twelve directors, four were public officials and eight were appointed by the governor, subject to approval by both houses of the state legislature; the authority is required by statute to submit a detailed initial plan for the use of general funds appropriated for the authority to the governor and the state legislature, and the authority is required to submit an annual report and financial statement to the governor and the state legislature). The ruling also found that the state had made a substantial financial commitment to the authority by contributing moneys to the authority.

PLR 200427016 held that a non-profit public corporation, formed by the state legislature to operate insurance plans that function exclusively as residual market mechanisms to provide essential property insurance for residential and commercial property, was as an integral part of the state for federal income tax purposes. The ruling found that the state had substantial control over the corporation (the directors include public officials and their designees, and members appointed by the commissioner or governor, all senior management serve at the commissioner's pleasure, the corporation must file regular financial reports and its plan of operation must be approved by the department, the corporation's rates are specified by legislation, and all bonds and other indebtedness of the corporation must be approved by a state commissioner). The ruling also found that the state had made a substantial financial commitment to the corporation (by enacting legislation authorizing the corporation to collect the premium tax and to retain the proceeds of the premium tax to augment the corporation's resources).

analysis was recently adopted by the Tax Court in *Uniband Inc. v. Comm'r* (holding that a corporation organized under Delaware law was not an integral part of an Indian tribe), the Service's long-standing refusal to acquiesce in the *Michigan* opinion means that the Service likely will continue to issue private letter rulings that conform to its current ruling position based on Rev. Rul. 87-2 and *Maryland Savings-Share*, namely that State control and financial commitment are necessary to establish that an enterprise is an integral part of the State.

PLR 200827004 concerned whether an amendment to state law requiring additional assessments from insurers participating in the state insurance fund would alter the previous private letter ruling finding that the insurance fund was an integral part of the state for tax purposes. The ruling found that the state maintained board control over the fund as it had before, and that the amendment had not materially altered the state's financial commitment to the fund, and held that the fund maintained its status as an integral part of the state.

Reliance on AGDC being treated as an integral part of the State is problematic, however, as the IRS has not been consistent over the years in their rulings on whether a corporation formed under a state statute will be treated as an integral part of the state or its subdivisions. Enterprises that would seem to qualify as an integral part of a state or its political subdivisions sometimes receive rulings that they qualify for tax exemption under § 115(1), under which the IRS currently will only issue a favorable ruling based upon a showing of no private benefit.⁹

In sum, AGDC's qualification for tax exemption as an integral part of the State or its political subdivisions cannot be assured without a favorable private letter ruling.

III. Whether AGDC Qualifies as a Section 115 Entity.

If AGDC were not to qualify for tax exemption either under implied statutory immunity as a political subdivision of the State, or as an integral part of the State or its political subdivisions, the next question is whether AGDC qualifies for tax exemption under § 115.

Code § 115(1) provides that the income of AGDC would be excluded from federal taxation if it is derived from the exercise of any essential government function and accrues to the State or any of its political subdivisions.

In private letter rulings, the IRS not only examines the § 115(1) criteria of whether income is derived from the exercise of an essential government function and accrues to the state or its subdivisions but also considers whether private parties would benefit from the entity. The most recent published ruling regarding tax exemption under § 115 is Rev. Rul. 90-74. Revenue Ruling 90-74 held that the income of a nonprofit organization formed by county governments of the state to pool the casualty risks of the member-counties was excluded from income under § 115(1), based upon findings that pooling casualty risks instead of purchasing commercial insurance constituted the exercise of an essential government function, that distribution of the assets of the organization upon dissolution to

⁹ E.g., PLR 8934052 (arts commission exempt under § 115, and not as integral part, because a state statute makes it a separate body "corporate and politic").

the member-counties satisfied accrual of income for purposes of § 115(1), and that private interests did not, “except for incidental benefits to employees of the participating state and political subdivisions, participate in or benefit from the organization.”

Essential Government Function

For ruling purposes, the IRS tends to regard anything that makes or saves money for a political subdivision as an essential government function:¹⁰

it may be assumed that Congress did not desire in any way to restrict a State's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the State government which, on a broad consideration of the question, may be the function of the sovereign to conduct.

Rev. Rul. 77–261. Revenue Ruling 77–261 held that a state investment fund, for the temporary investment of cash balances of the state and its political subdivisions, “constitutes the exercise of an essential governmental function for purposes of section 115(1) of the Code.”

A recent private letter ruling with many similarities to the Project, PLR 200524015, found that a nonprofit corporation formed by political subdivisions of the state, consisting of natural gas and electric joint action agencies and distribution systems, qualified for exemption under § 115(1). The ruling specifically found that acquiring and financing long-term natural gas supplies, acquiring, constructing, owning, managing, operating and financing natural gas pipelines, liquefied natural gas facilities, storage and related facilities and equipment, and contracting with joint action agencies and public gas or power systems to provide them with natural gas supplies all constituted an essential governmental purpose within the meaning of § 115(1).

Accrual

In order to obtain a private letter ruling under § 115(1), an organization must show that it has satisfied the accrual test by including in its articles of organization a provision limiting distribution upon dissolution of all of AGDC's assets

¹⁰ April at 816. Note that there is very little contemporary authority that taxpayers are entitled to rely on, beyond the revenues rulings cited herein, for what constitutes “an essential governmental function” for purposes of §115(1). Case law is less than clear– the United States Supreme Court has concluded that it is essentially impossible to define what an essential governmental function is. The Supreme Court in *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) concluded that “[t]here is not, and there cannot be, any unchanging line of demarcation between essential and non-essential governmental functions.”

to one or more States, political subdivision(s) thereof, the District of Columbia, or to other organizations whose income is excluded from gross income under section 115(1).

Rev. Proc. 2003-12.

AGDC is a corporation specifically authorized by statute, AS 31.25. Alaska Statutes 31.25.010 provides that “[u]pon termination of [AGDC], its rights and property pass to the state,” which appears to comply with the ruling requirements of Rev. Proc. 2003–12.

Note that the courts have been less generous in their interpretation of what is required to satisfy the accrual requirement for tax exemption under § 115(1) than the ruling position of Rev. Proc. 2003-12,¹¹ which only requires disbursement of assets upon dissolution to the state or its political subdivisions to satisfy the accrual requirement. For instance, *City of Bethel v. U.S.*, 594 F.2d 1301 (9th Cir. 1979), *cert. denied*, 444 U.S. 980 (1979)¹² held that the mere accrual of income to a corporation owned by the governmental entity is not considered accrual to the governmental entity. The fact that the assets will revert to the state upon the corporation's dissolution, that the government was the sole owner of the corporation, or even that the state may request payment of profits at any time, did not qualify as direct accrual.

No Private Benefit

The IRS ruling position, that an entity cannot qualify for tax exemption under § 115 if it serves a private interest that is not incidental to the public interest, has no statutory basis. This requirement was apparently first asserted in PLR 8825027, the ruling that denied the Michigan Education Trust exemption under § 115 (a ruling that was effectively reversed by the Sixth Circuit in *Michigan v. United States*). *Id.* at n. 4.

To qualify under section 115, it must be established that the income does not serve private interests such as designated individuals, shareholders of organizations, or persons controlled, directly or indirectly, by such private interest. Thus, even if the income serves a public interest, the requirements of section 115 are not satisfied if the income also serves a private interest that is not incidental to the public interest. The basic principle underlying section 115 is that property (including any income thereon) must be devoted

¹¹ Rev. Proc. 2003-12 only addresses ruling requirements for a § 501(c)(3) organization that requests a ruling that it is also exempt under § 115(1), but likely reflects the Service's ruling position for an entity affiliated with a state that requests a ruling under § 115(1).

¹² The *City of Bethel* is a Ninth Circuit case, and is binding authority for AGDC.

to purposes which are considered beneficial to the community in general, rather than particular individuals.

PLR 8825027.

IRS rulings from the 1990s regarding state-sponsored disaster funds designed to deal with private insurance companies pulling out of the market for insuring certain forms of risk illustrate the risk that AGCD's involvement in the Project might be considered by the IRS to benefit private parties. For instance, the Florida and California private letter rulings, respectively PLR 9507037 and PLR 9622019, both found that the respective state disaster funds qualified for tax exemption as integral parts of their respective states, and concluded that, because the fund was an integral part, § 115 did not apply to the fund. Technical Advice Memorandum 94347001 reviewed another state's disaster fund and found that, besides failing to qualify as an integral part of the state or as a political subdivision of the state, the disaster fund also did not qualify for exemption under §115.

In declining exemption under §115, TAM 94347001 noted that "the sole purpose of [the fund] is to provide commercial-type insurance for private entrepreneurs," and specifically contrasted the fund with the risk pool at issue in Rev. Rul. 90-74, which pooled the risk exposure of political subdivisions of the state, and where private interests did not benefit more than incidentally. The disaster funds in Florida and California that received favorable rulings in PLR 9507037 and PLR 9622019 likely would not have qualified for exemption under §115 under the same analysis, as those disaster funds primarily benefited the private individuals seeking insurance coverage that they had not been able to obtain from the private insurance market. See Aprill at 828-830.¹³

AGDC's only owner will be the State or one of the State's political subdivisions. All distributions of AGDC are required by AS 31.25.110 to be distributed to an appropriate fund as determined by the commissioner of revenue in consultation with the commissioner of natural resources. While AS 31.25.110 is not clear on this point, the "appropriate fund" restriction seems intended to bar distributions from AGDC to anything other than a political subdivision or instrumentality of the State. The lack of clarity in what is an "appropriate fund" conceivably could be interpreted by the IRS as allowing the possibility of a private benefit from the fund.¹⁴

¹³ Also discussing the considerable congressional pressure that was applied by the delegation of California to ensure that California received and retained a favorable private letter ruling.

¹⁴ It is perhaps conceivable that the IRS could also find that the State's investment in, and ownership of, a minority interest in the Project, while providing additional royalty and tax revenue for the State and for the energy needs of the people of Alaska, could more than incidentally benefit the other investors in the Project.

It will be essential for the State to secure a favorable private letter ruling recognizing federal tax exemption under § 115 if AGDC intends to rely on exemption under that provision.

IV. Instrumentalities.

Alaska Statutes 31.25.010 states that AGDC is “a public corporation and government instrumentality . . .” (emphasis added). For tax purposes, an instrumentality is, by definition, an entity that is not a state or a political subdivision of a state. §§ 3121(b)(7)(F), 3306(c)(7) and 414(d); Rev. Rul. 57–128.

With the exception of certain corporations organized under an act of Congress as instrumentalities of the United States, status as an instrumentality does not indicate whether a corporation such as AGDC is exempt from federal taxation. Code § 501(c)(1) and Rev. Rul. 77–271. Revenue Ruling 77–261 concerned an investment fund established by a state treasurer that was “specifically designated as an instrumentality” of the state. After finding that the investment of funds was the exercise of an essential governmental function and after finding that the fund’s income accrued to the state and the participating political subdivisions of the state, Rev. Rul. 77–271 held that income of the investment fund was exempt from federal income tax under §115(1).¹⁵

Designation as an instrumentality has significance for social security tax, federal unemployment tax and eligibility for governmental pension plans. §§ 3121(b)(7)(F), 3306(c)(7) and 414(d). The IRS analyzes whether an organization qualifies as an instrumentality for such purposes under the criteria set forth in Rev. Rul 57-128:

(1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses.

If the IRS concluded that AGDC was an instrumentality, and not a political subdivision or an integral part of the State, it would examine whether AGDC qualified for

¹⁵ In other words, Rev. Rul. 77 – 261 held that the investment fund qualified for tax exemption under § 115(1); that holding was not based on the fund’s status as an instrumentality of the state.

federal tax exemption under either § 115(1) (discussed above) or § 501(c), primarily § 501(c)(3) (discussed below). Aprill at 821.

If AGDC is considered an instrumentality of the State, it will be essential for the State to secure a favorable private letter ruling recognizing federal tax exemption under § 115 if AGDC does not qualify for exemption as a political subdivision of the State or as an integral part of the State.

V. § 501(c)(3) Organizations.

AGDC, as a “public corporation and instrumentality” of the State could qualify for exemption under §501(c)(3) if it were a “clear counterpart” of a charitable, educational, religious or like organization. Rev. Rul. 60–384; see also Rev. Rul. 55–319. There is at least an issue whether the IRS would consider AGDC, investing in a liquefied natural gas Project, to be a “clear counterpart” of a charitable organization.

Further, if AGDC is an integral part of the State, which it would seem to be if it does not qualify a political subdivision, it would not qualify for exemption under §501(c)(3). Revenue Ruling 60-384 ruled that because a state's purposes include those not exclusively described in § 501(c)(3), an organization that is an integral part of the state cannot meet the requirements for exemption under § 501(c)(3).

Finally, if AGDC's powers exceed the scope of those allowed by § 501(c)(3), AGDC would not qualify for exemption under § 501(c)(3). Rev. Rul. 60-384. AGDC's regulatory powers, discussed above, appear to disqualify AGDC as a § 501(c)(3) organization. Id. In Rev. Rul. 74–14, a public housing authority was denied exemption under § 501(c)(3), even though its purpose was to provide safe housing accommodations for low income families, because the state statute incorporating the authority gave it the power to conduct examinations and investigations for the purpose of collecting information and making it available to appropriate agencies for use in furthering and enforcing local ordinances regarding planning, building, and zoning matters. Revenue Ruling 74–14 concluded this power to conduct examinations and investigations was a regulatory power that was inconsistent with exemption under § 501(c)(3).

For reasons such as those set forth above, § 501(c)(3) seems the least likely ground for AGDC to qualify for federal tax exemption.

VI. Conclusion.

The State is strongly recommended to secure a private letter ruling confirming that AGDC qualifies for tax exemption at the earliest opportunity, as AGDC's involvement in the Project will require substantial State investment. If SB 138 and HB 277 are enacted into law, the ruling request should be made shortly thereafter.

In order to facilitate securing a favorable ruling, the Committee is also advised to incorporate the changes discussed in principle at page 8 of this letter into SB 138 and HB 277, to better establish that AGDC's qualifies for implied statutory immunity as a political subdivision of the State.

Notice Regarding Tax Advice

We hope that this letter helps explain the federal tax exemption issues raised by the Project and the related pending legislation. We would be happy to expand upon our analysis should the Committee or the Legislature so desire or to address any particular questions that the Committee or the Legislature may have.

This letter has been prepared solely for use by the State, the Legislative Budget & Audit Committee, and the Alaska state legislature. Any tax advice contained in this letter was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

The advice in this letter is not binding on the Internal Revenue Service, any court, or any other person or entity. The Internal Revenue Code has been subject to substantial and frequent revisions in recent years. We cannot assure that forthcoming IRS interpretations, administrative pronouncements, or court decisions will not adversely affect the tax advice given in this letter.

Realization of federal tax exemption is subject to the risk that the Internal Revenue Service may challenge tax treatment and that a court may sustain that challenge. Because taxpayers carry part of the burden of proof required to support the tax treatment of a transaction, the advice expressed as to the likelihood of realization of federal tax exemption assumes that you will undertake the effort and expense to request an appropriate private letter ruling and present fully the State's case in support of any matter that the Service challenges.

Sincerely,

MANLEY & BRAUTIGAM, P.C.

By:


Charles F. Schuetze