IRS LETTER RULINGS

Letter Ruling Alert

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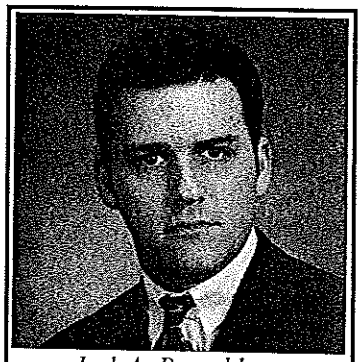
State Chartered Educational Institution Entitled to a Higher Interest Rate on Employment Tax Overpayments

Introduction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In TAM 200126032, (September 14, 2000; reprinted at p. 277), the IRS ruled that an employment tax refund issued to a state chartered educational institution is not subject to a lower interest rate that is applied to corporate tax over-payments under section 6621(a)(1), despite the fact that the institution identified itself as a corporation and filed a Form 990-T. In reaching its conclusion, the IRS determined the following: (1) that the educational institution was an "integral part" of the state and thereby not a separate corporation; (2) that the tax overpayment made by the educational institution was the result of activities that were entirely related to the institution's exempt purpose; and (3) that the filing of Form 990-T by the educational institution was irrelevant in determining its relationship with the state.

Facts

X Corporation is an institute of higher education that was created by the legislative assembly of Territory Z pursuant to the laws of Territory Z (the Laws). The Laws also provide that the governance of X shall be vested in a Board of Regents, which shall consist of 12 persons elected by the legislature who shall serve in a capacity similar to that of a Board of Directors and shall have the right to be sued, to contract, and to use a common seal. The Regents hold their offices for six years and are elected by the legislature. The charter of X does not expressly grant the legislature the power to remove a Regent, either with or without cause. However, the legislature always has the right not to reelect a Regent whose service to X has been unsatisfactory.

Financial control of X is vested in both the executive and legislative branches of the Z government. X is required to submit annual financial reports to the Z legislature and obtain its approval for salary appropriations and building purchases. X must also make its books, accounts, and documents available for inspection by the Z Commissioner of Finance and to a legislative auditor for an annual audit similar to that conducted on other state agencies. State of Z law requires that all non-academic employees who are employed by X be paid salaries and benefits that are comparable to those paid to other state workers in the civil service. Any collective bargaining with unions is performed in accordance with the State of Z's Public Employment Labor Relations Act, under which the Board of Regents of X is defined as a "public employer" and their employees are defined as "public employees." The State of Z generally views employees of X as if they are employees of the State of Z. However, academic employees of X, who represent one-third of the employees of X, participate in their own benefits program which is unrelated to the state program in which the non-academic employees participate.

From its inception, X has been and continues to be financially supported by Z. In any given year, appropriations from the state may account for 20 percent to 32 percent of the fiscal year revenues relied upon by X to fund its operations. On June 25, 1941, X was deemed by the IRS to be an instrumentality of Z, and thereby exempt from income tax and not required to file income tax returns. In 1961, X applied for a federal tax exemption as an organization described under section 501(c)(3), so that X's employees could avail themselves of the tax treatment provided under section 403(b) of the code. On August 21, 1961, X was recognized as a tax-exempt organization under section 501(c)(3) as an instrumentality of the State of Z. Further, on December 24, 1970, X was notified that it was now classified by the IRS as an organization not a private foundation, as defined in section 509(a), but as an organization described under section 509(a)(1) and section 170(b)(1)(A)(ii).

X maintains its own campus police force that functions in the same manner and with the same authority as do the local county and municipal police forces. X is also authorized by a State of Z statute to adopt traffic rules and regulations for streets and roads located on X property and to employ officers to enforce the laws and assess fines for violations.

The IRS Master File indicates that X is not required to file Form 990. However, X is required to file Form 990-T. On the face of the 990-T, X identified itself as a corporation.

X timely filed a refund claim for overpaid employment tax for the calendar years ending December 31, 1990 through June 30, 1998. Each quarter's refund exceeded $10,000. In February 1999, the IRS granted X's refund request for such years in question. Along with the employment tax refund, X received an interest payment that was computed by the IRS. In making its computation of the interest payment due the educational institution, the IRS categorized X as a "corporation," making X subject to the reduced interest rates for

corporate over-payment to which corporations are subject under section 6621(a)(1). The reduced interest rate was applied to X's claims for the interest periods beginning after December 31, 1994.

In contrast to the IRS's computations of the interest due to X pursuant to the refund claim, X performed its own interest computations and determined that the IRS computation is deficient by $1.9 million. X made its computation based upon the assumption that it was not subject to the lower overpayment rates applicable to corporations under section 6621.

The FICA tax refund claims did not arise with respect to any of the activities of the employees associated with X's unrelated trade or business filed on the Form 990-T; instead, such refund claims are related solely and entirely to X's exempt function activities.

Relevant Law and Analysis

Separate Entity

The IRS looked initially at the question of whether X was appropriately defined as an entity separate and apart from the State of Z. In its analysis, the IRS reasoned that federal tax law governs whether an organization is classified as an entity separate and apart from its owners and that such a classification is not dependent upon whether the organization is recognized as an entity under local law. Treas. reg. section 301.7701-1(a). An entity formed under local law is not always recognized as a separate entity for federal tax purposes if such an entity is an integral part of the state. Treas. reg. section 301.7701-1(a)(3). In supplementary information to the Treasury regulations, T.D. 8697 1997-1 C.B. 215 further emphasizes that federal tax law controls the determination of whether a separate entity exists when such entity is a corporation.

In *State of Michigan v. United States*, 40 F.3d 817 (6th Cir.1994), a Michigan Education Trust created by the Michigan legislature was determined to be a public instrumentality of the state of Michigan and therefore not a separate corporation, despite its status under local Michigan law. In reaching its decision, the IRS cited GCM 14,407, XIV-1-Cum.Bull. 103 (1935), in which IRS concluded that a state or political subdivision is not a "corporation" for purposes of the code.

In Rev. Rul. 60-384, 1960-2 C.B.172, the IRS discussed the circumstances of when a wholly owned state or municipal instrumentality, which is a separate entity and is organized and operated exclusively for the purposes set forth in section 501(c)(3), may fail to qualify as a separate entity. The example cited in the ruling applies directly to the facts presented in the TAM, dealing with the situation where a public school, college, university, or hospital is an integral part of a local government; it cannot meet the requirements for exemption under section 501(c)(3).

Integral Part Test

After determining whether X existed as a separate entity, the next step in the IRS analysis was to decide whether X was an integral part of the State of Z. The IRS cited Rev. Rul. 87-2, which dealt with a state lawyers' trust account to find the factors that are used to determine whether an organization is in fact an integral part of the state. The major factors are as follows: (1) whether the members of the fund are directly or indirectly appointed by the supreme court of the state; (2) whether the state supreme court may or may not remove any member of the fund without cause; (3) whether the fund is required to make quarterly reports to the court; and (4) whether the supreme court monitors the activities of the fund by having a judge of the supreme court present at all of its meetings. In addition to these factors, the Service distinguished between two types of integral parts, the first being where an organization is made up of or dominated by state officials, or the second, which is the case in the TAM, whereby the organization is "clothed with powers that are governmental in such a manner as to preclude the organization from qualifying as a clear counterpart of a section 501(c)(3) organization." Examples of the second type of integral part include police powers, regulatory powers, the power to tax and perhaps, the power of eminent domain. See also Rev. Rul. 74-14 for an example of regulatory enforcement power that rose to the level of precluding its qualification under section 501(c)(3).

In making its determination that X was an integral part of the State of Z, under the test enunciated above, the IRS focused carefully on the following factors supporting that determination: (1) that the members of the X Board of Regents are elected by the State of Z legislature and that any vacancies in such board are temporarily filled by the governor; (2) that X is required to report annually to the legislature on the status and progress of X; (3) that the Board of Regents is required by state law to submit the proposed salaries of X faculty and other officers to the legislature for its approval; (4) both the executive and legislative branches of the government exercise financial controls over X; (5) state law requires X to consult with the chairs of the Senate Finance Committee and House Ways and Means committee before purchasing or erecting buildings; (6) that X must permit the Commissioner of Finance to inspect all books, accounts, documents, and property that the commissioner wishes to inspect; (7) that the legislative auditor must perform an annual audit of X still in the same manner as he or she does with other state agencies; (8) X is considered a part of the state for membership in its Worker's Compensations Reassurance Association; (9) many of the salaries and benefits paid to non-academic employees of X are comparable to those received by other state employees; (10) for the purposes of collective bargaining, health care, pension benefits, job transferability and in many other respects, non-academic employees are treated in much the same way as state employees; (11) X receives hundreds of millions of dollars a year in financial support from the state; (12) the existence of police regulatory power granted to X; and (13) X's powers of eminent domain.

The IRS also considered factors that work against X being deemed an integral part of Z. These factors are as follows: (1) it appears that state legislature of Z neither has the power nor does it exercise the power to remove members of the Board of Regents, and (2) the academic employees of X are not treated in many ways similar to employees of State Z

(however, the legislature has the important power of approving salaries of academic employees).

In summarizing all of the factors and balancing them against each other, the IRS reasoned that without a doubt, X is an integral part of the State of Z. Therefore, the federal tax exemption granted to X under section 501(c)(3) in 1961 was issued in error and X is not entitled to an exemption.

Other Considerations

X is subject to the tax on unrelated business income imposed by section 511 and applied to state colleges and universities by section 511(a)(2)(B) of the code. X listed itself as a corporation in filing and thereby filed Form 990-T for the fiscal years 1991 to 1998.

Arguments have been made that by filing a Form 990-T as a "corporation," an organization is entitled to a lower credit interest rate for large corporate tax overpayments under section 6621(a)(1). In its determination, the IRS explicitly disagreed with this argument and determined that filing status on a Form 990-T was not significant in making this determination. The IRS reasoned that an income tax form is not authority for establishing entity relationships for federal tax purposes, particularly when a different matter than that for which the form is being filed is at issue, and that tax forms are not always designed to capture all of the complex issues and permutations contemplated by the code.

Both X and the District Director agree that the tax overpayment leading to the interest on the refund of taxes under section 6621(a)(1) was entirely related to X's exempt function and bears no connection to its unrelated business taxable income. Therefore, the filing of Form 990-T is irrelevant to the issue based on overpayment under section 6621(a)(1). The IRS deemed this issue to be no longer relevant to its discussion.

Conclusion

First, the IRS concluded that X should not be treated as a corporation for federal tax purposes, because the facts and circumstances indicate that it is not a separate entity and that it constitutes an integral part of the State of Z. Therefore, X was issued a tax exemption ruling as an organization described under section 501(c)(3) in 1961 in error and is not subject to the lower interest rate on tax overpayments proscribed by section 6621(a)(1) for "corporations."

Second, in the case of an entity subject to unrelated business income tax imposed under section 511(a)(2)(B) of the code, the corporate overpayment rates do not apply to employment tax refunds when the employment services to which the rates relate do not fall within the scope of a related trade or business.

Third, the filing of a Form 990-T was irrelevant in classifying the entity as a corporation for federal tax purposes.

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IRS Technical Advice

Section 115 — State and Municipal Income

STATE SCHOOL GETS HIGHER INTEREST RATE ON EMPLOYMENT TAX REFUND. The Service ruled in **technical advice** that the employment tax refund of a state-chartered educational institution is not subject to the lower interest rate on corporate tax overpayments, even though the institution filed a Form 990-T and identified itself as a corporation.

The institution was created by state charter in 1851, and is the only institution of higher education in the state that has had its existence and purposes mandated by the state's constitution. In 1941, the Service ruled that the institution was a tax-exempt instrumentality of the state. By 1970, the IRS had recognized the institution as an organization described in sections 501(c)(3) and 170(b)(1)(A)(ii).

Although the institution was not required to file Form 990, it was required to file Form 990-T, on which it identified itself as a corporation. When the institution filed employment tax claims for overpaid taxes, the Service allowed the claims but calculated the interest payment at a reduced rate applicable to corporate tax overpayments. The institution requested a ruling to determine the relevance of filing the Form 990-T in the computation of interest on tax overpayments. The ruling request also sought to clarify whether the corporate overpayment rates applied to employment services that are not performed in an unrelated trade or business.

After first determining that the institution was an integral part of the state, the Service concluded that the tax overpayment was a result of activities that were entirely related to the institution's exempt purpose. Thus, the Service ruled that the institution was not subject to a reduced interest rate on its employment tax refund. The Service further concluded that the filing of the Form 990-T was irrelevant in determining entity relationships. Although "some argue that section 6621(a)(1) established a lower credit interest rate for . . . overpayments where the organization files Form 990-T . . . how one may fill out an income tax form is not authority," the Service responded.

Full Text Citations: *TAM 200126032; Doc 2001-17922 (13 original pages); 2001 TNT 127-31; LTRServ,* July 9, 2001, p. 3597; reprinted at p. 277.

Section 162 — Business Expenses

PAYMENT TO STATE AS PART OF DEMUTUALIZATION IS DEDUCTIBLE. In **technical advice**, the Service has ruled that a payment by a nonprofit mutual health insurer to a state as part of the company's conversion to a for-profit stock insurer is deductible under section 162.

The insurer, a state nonprofit corporation, was originally organized as a "health services plan," which was regulated