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What are Government Entities and Their Federal Tax Obligations?



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Federal and state governments are established and recognized by the U.S. Constitution and state constitutions. Federally recognized Indian tribal governments are recognized by the U.S. Constitution, treaties, statutes and court decisions. Other entities may be recognized as governments by state law, court decision, or an examination of facts and circumstances that indicate it has the characteristics of a government, such as powers of taxation, law enforcement and civil authority.

Many tax laws apply differently to government entities than to other organizations and individuals. The primary tax difference from other taxpayers is the general exemption from income tax. IRC Section 115 excludes from gross income any income derived from the exercise of or administration of any public function.

Federal tax obligations

[Employment taxes](#)

Also known as *payroll taxes*, government entities must withhold federal income tax from employees' wages.

[Social Security & Medicare](#)

Government entities may be required to withhold social security and Medicare taxes from employees' wages and pay a matching amount.

[Section 218 Agreements](#)

State and local government entities may be covered by Section 218 agreements that affect their social security & Medicare withholding requirements.

[Retirement plan reporting](#)

Retirement plans must file certain forms and reports with the IRS and the Department of Labor and send out notices to plan participants and certain others.

What are government entities?

In most cases it is clear that an entity is governmental; however, in some cases it may not be immediately clear. The identity of an entity as a government is based on constitutional, federal, and state law, as well as on court decisions.

Below are the different types of government entities and how each authority is established.

State Government

Although states are recognized as entities by the U.S. Constitution, different definitions of a "state" apply for different legal purposes. Federal employment taxes generally apply to all 50 states, the District of Columbia and all U.S. Territories. For purposes of a Section 218 Agreement, a state includes the 50 states, Puerto Rico, the Virgin Islands and interstate instrumentalities. It does not include the District of Columbia, Guam, American Samoa or the Commonwealth of the Northern Mariana Islands.

The states have primary responsibility for many aspects of government. The 10th Amendment to the U.S. Constitution reserves to the states or to the people all powers not delegated nor prohibited by the Constitution. Some services for which the state has primary responsibility include:

- Protection of lives and property by maintenance of a police force
- Regulation and improvement of transportation within the state
- Regulation of business within the state
- Education

Local Government and Subdivisions

Local governments are generally political subdivisions of states and differ from state and federal governments in that their authority is not based directly on a constitution. Each state constitution describes in detail a procedure for establishing local governments. In most cases the state legislature must approve the creation or incorporation of a local government. The local government then receives a charter defining its organization, authority and responsibilities, including the means for electing governing officials.

Local government units bear a variety of names, such as city, county, township, village, parish, district, etc. The legal significance of these terms may vary from state to state.

The authority of local governments varies greatly. Generally, a local government has the authority to:

- Impose taxes

- Try people accused of breaking local laws or ordinances
- Administer local programs within its boundaries

Indian Tribal Governments

Tribal entities are recognized as governments under Federal law. Numerous statutes establish the treatment of tribes for Federal tax purposes and the criteria for identifying state and local governments discussed below do not apply. For more information on the tax treatment of tribes, see [Indian Tribal Governments](#).

Instrumentalities

An instrumentality is an organization created by or pursuant to state statute and operated for public purposes. Generally, an instrumentality performs governmental functions, but does not have the full powers of a government, such as police authority, taxation and eminent domain. A wholly-owned instrumentality of one or more states or political subdivisions is treated as a state or local government employer for purposes of the mandatory social security and Medicare provisions and also applies to entities covered under Section 218 of the Social Security Act. See IRC section 3121(b)(7)(F).

An interstate instrumentality is an independent legal entity organized by two or more states to carry on governmental functions. Examples include a regional planning authority, transportation system or water district. For purposes of Section 218, an interstate instrumentality is treated as a state.

In Revenue Ruling 57-128, the IRS addressed the question of whether an organization is wholly-owned by one or more states or political subdivisions. In making this determination, the following factors are taken into consideration:

- Whether it is used for a governmental purpose and performs a governmental function
- Whether performance of its function is on behalf of one or more states or political subdivisions
- Whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner
- Whether control and supervision of the organizations is vested in public authority or authorities
- Whether express or implied statutory or other authority is necessary for its creation and/or use of the instrumentality, and whether such authority exists
- The degree of financial autonomy and the source of operating expenses

Characteristics of Instrumentalities

Schools, hospitals and libraries, as well as associations formed for public purposes, such as soil and water conservation, may be instrumentalities, depending on the facts and circumstances. State sponsorship of an organization, state regulation of its activities, the participation of its employees in a public retirement system and operation with public funds are among the factors to be considered in determining whether an organization is an instrumentality. If an organization is essentially under private ownership and control, it is not an instrumentality. Associations formed for conservation, protection and promotion, although carrying out a public purpose, may not rise to the level of state instrumentalities. The following associations may or may not be state instrumentalities:

- Soil and water conservation districts
- Fire associations that protect forestland
- Associations that promote a state or municipality

To determine the status of an entity, it is essential to review the documents that establish statutory authority. The following cases elaborate on the principles established in IRS Revenue Ruling 57-128.

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