Section of Taxation

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May 5, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Definition of Political Subdivision.

Dear Commissioner Koskinen:

Enclosed please find comments requesting guidance on the definition of political subdivision for tax exempt bonds and other tax-advantaged bonds ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Tom West, Tax Legislative Counsel, Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Victoria Judson, Associate Chief Counsel (Tax Exempt & Government Entities), Internal Revenue Service
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON THE DEFINITION OF POLITICAL SUBDIVISION FOR TAX EXEMPT BONDS AND OTHER TAX-ADVANTAGED BONDS

These comments (the "*Comments*") are submitted on behalf of the American Bar Association Section of Taxation (the "*Section*") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Mark Norell of the Section's Committee on Tax Exempt Financing (the "*Committee*"). Substantive contributions were made by David Cholst, Matthias Edrich, James Eustis, Carol Lew, Scott Lilienthal, Vanessa Lowry and Victoria Ozimek. Assistance was also provided by Courtney Chen of the American Bar Association's Law Student Division. The Comments were reviewed by Nancy M. Lashnits, Chair of the Committee, Stefano Taverna, Vice Chair of the Committee, John O. Swendseid, of the Section's Committee on Government Submissions. The Comments were further reviewed by Peter H. Blessing, the Section's Vice Chair (Government Relations).

Although the members of the Tax Exempt Financing Committee who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 5, 2015

EXECUTIVE SUMMARY

These Comments are submitted in connection with the 2014-2015 guidance project announced by the Department of the Treasury ("*Treasury*") and the Internal Revenue Service (the "*Service*") regarding the term "political subdivision."[1]

For interest on a bond to be excluded from gross income for federal income tax purposes, the bond must be a "state or local bond" under section 103(a).[2] Regulation section 1.103-1(a), in relevant part, provides:

> Interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "State or local governmental unit") is not includable in gross income ….

Regulation section 1.103-1(b) further provides:

> The term "political subdivision," for purposes of this section denotes any division of any State or local government unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

The leading case that considered a predecessor version of the above Regulations, *Commissioner of Internal Revenue v. Shamberg's Estate* ("*Shamberg*"),[3] held that there are three elements of sovereign power: (1) the power of eminent domain, (2) the power to tax, and (3) the police power. Although *Shamberg* only required that part or a portion of those powers be present to conclude that an entity created under state law for a governmental purpose is a political subdivision, subsequent authorities indicate that possession of only an insubstantial amount of any or all sovereign powers is not sufficient. From time to time, the Service has issued administrative guidance following *Shamberg*, elaborating on the amount and type of sovereign powers sufficient for such qualification. Thus, until recently the definition of a political subdivision has been understood to be settled and limited to the considerations set forth in *Shamberg*, with questions mainly arising as to whether an entity has sufficient sovereign powers to be a political subdivision.[4]

The definition of a political subdivision for purposes of tax-advantaged financings came back to the forefront in Technical Advice Memorandum 201334038 (the "*2013 TAM*"). The

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[1] Under the initial 2014-2015 Priority Guidance Plan, and the most recently published plan (the second quarter update), both available at http://www.irs.gov/uac/Priority-Guidance-Plan, there is a project listed in the Tax Exempt Bonds section for "Guidance on the definition of political subdivision under Section 103 for purposes of the tax exempt, tax credit, and direct pay bond provisions."

[2] References to the "section" refer to the Internal Revenue Code of 1986, as amended (the "*Code*"); and all references to the Regulations refer to income tax regulations promulgated under the Code.

[3] 144 F. 2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). *Commissioner v. White's Estate*, 144 F.2d 1019, 44-2 U.S.T.C. 710 (2d Cir. 1944), cert. denied, 323 U.S. 792, 65 S. Ct. 433 (1945) ("*White's Estate*") was a companion case to *Shamberg* and examined bonds issued by the Triborough Bridge Authority.

[4] A relatively succinct statement of the law is provided in the quoted language from GCM 36994 (February 3, 1977) set forth at part III.F of the Discussion below. The GCM goes so far as to state that "we consider the meaning of political subdivision for purposes of section 103(a)(1), to be well established."

2013 TAM addresses the status of a particular issuer (the "*Issuer*") as a political subdivision. Parts of the 2013 TAM appear to set forth new substantive requirements not previously considered in the various statutory, administrative or judicial precedents. The 2013 TAM states that:

> [t]he term "political subdivision" is defined in Reg. § 1.103-1(b) as "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."
> …
> The phrase "division of a state or local government" must be read in the context of the purpose of Section 103, which is to provide subsidized financing for state and local government purposes. The Code permits the benefit of this subsidy to be passed on to private persons under some circumstances, but only if a governmental unit determines that the issuance of such bonds is appropriate. A governmental unit is inherently accountable, directly or indirectly, to a general electorate. In effect, Section 103 relies, in large part, on the democratic process to ensure that subsidized bond financing is used for projects which the general electorate considers appropriate state or local government purposes. A process that allows a private entity to determine how the bond subsidy should be used without appropriate government safeguards cannot satisfy Section 103.

The 2013 TAM concludes that because the Issuer is not directly or indirectly answerable to the electorate, it is not a division of a state or local government, and therefore it is not a political subdivision that may issue tax exempt bonds. The TAM points to the "division" language in Regulation section 1.103-1(b) to require "accountability, directly or indirectly, to a public electorate." As discussed more fully herein, accountability has not previously been required to achieve political subdivision status and control has been analyzed as a factor in whether sovereign power has been delegated,

The Committee is concerned that auditors of tax exempt bonds may use the 2013 TAM to apply a new standard not based on existing law, thereby creating significant uncertainty in a well-established transactional practice that relies on unqualified tax opinions. Audits based on the new analysis in the 2013 TAM could have a substantial adverse impact on existing issuers and could prove costly to state and local governments. Moreover, although the 2013 TAM cannot be used as precedent, the mere presence of the quoted language in a published administrative determination creates uncertainty with regard to the standard to be applied by a tax lawyer, an issuer, or the Service when evaluating political subdivision status of an entity.

It is not the objective of these Comments to make any comment about whether the Issuer in the 2013 TAM qualifies as a political subdivision. Instead, in light of the new requirements that the 2013 TAM seems to impose to qualify as a political subdivision, we recommend that the 2013 TAM be withdrawn or modified to conform with existing precedent. The Committee also recommends that the Service and Treasury issue a notice providing interim guidance prior to the issuance of new political subdivision regulations and stating that any change to the definition of political subdivision will apply solely on a prospective basis.

The remainder of these Comments first provides a more in depth discussion of the 2013

TAM, second provides a review of existing law on the issue of political subdivision as it relates to the issuance of tax advantaged obligations, and, third, provides an analysis of existing law in the context of the 2013 TAM and new regulations addressing political subdivision status.

DISCUSSION

I. DISCUSSION OF THE 2013 TAM

The 2013 TAM outlines a two-part test for determining whether an entity may issue bonds the interest on which is exempt from gross income for federal income tax purposes. This test requires both that (1) the entity be "a division of a state or local government" and (2) it be delegated sufficient sovereign powers.[5]

Because of questions about control from the Service, the Issuer in the 2013 TAM argued that it was sufficiently controlled by the state to be a political subdivision and pointed to numerous legal restrictions placed upon it by state law. The Service disagreed that these restrictions were sufficient because the restrictions did not "address the fact [that] the [i]ssuer was organized and operated to perpetuate private control and avoid indefinitely responsibility to a public electorate, either directly or through another elected state or local governmental body."

The 2013 TAM did not rely on any authority involving tax exempt bonds in concluding that the issuer in the 2013 TAM is not a political subdivision. Rather, the only authority cited was Rev. Rul. 83-131,[6] which held that certain North Carolina electric and telephone *membership corporations* are not exempt from diesel fuel excise taxes and other federal excise taxes on four different grounds.[7] The 2013 TAM summarizes Rev. Rul. 83-131 as follows:

> [the membership] corporations did not qualify as political subdivisions, in part because they were 'not controlled directly or indirectly by a state or local government,' but rather by a board of directors 'independent of such authority.'

After concluding that such membership corporations were not divisions of a state or local governmental unit and did not have sufficient sovereign power to be political subdivisions, the revenue ruling inquired whether the membership corporations would nevertheless be eligible for excise tax exemptions because sales "could be considered to be made for the exclusive use of a state or local government." As described more fully below, the 2013 TAM quoted from the discussion in Rev. Rul. 83-31 that addressed an excise tax exception and not from the analysis that determined the political subdivision status of the membership corporations.

As discussed more fully below, Rev. Rul. 83-131 does not provide support for the new requirements set forth in the 2013 TAM for political subdivision status, *i.e.*, accountability to a general electorate. Neither the language of Rev. Rul. 83-131, nor the related GCM, address the criteria set forth in the 2013 TAM, *i.e.*, the requirement of inherent accountability, directly or indirectly, to a general public electorate; appropriate safeguards to prevent a private entity from determining how the bond subsidy should be used; and a general public to which the general electorate is responsible. If these additional requirements are to be imposed, they should be developed through a process whereby the public is provided an opportunity to comment.

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[5] The "Law and Analysis" section of the 2013 TAM has two subsections: the first, "Is Issuer a Division of a State or Local Government?" and the second, "Has Issuer been Delegated Sovereign Power?"

[6] 1983-2 C.B. 184.

[7] The Service cites this authority with the citation signal "Cf." which ordinarily tells the reader that the cited authority provides only indirect support by analogy for the author's proposition.

II. CURRENT LAW: CASES AND REVENUE RULINGS

In considering an entity's political subdivision status for purposes of issuing tax exempt bonds, the Service and Treasury should look solely to existing cases, authorities cited in those cases, regulations and published rulings that deal directly with political subdivision status of entities that issue tax advantaged bonds. The key authorities, in addition to the regulations, are the three court cases, an Attorney General Opinion, and four revenue rulings, all of which are summarized below.

A. Commissioner of Internal Revenue v. Shamberg's Estate and the 1914 AG Opinion

As discussed briefly above, *Shamberg* was one of the first cases to interpret the meaning of "political subdivision" in the context of tax exempt bonds. *Shamberg* analyzed the exclusion from gross income of interest on bonds held by Alexander Shamberg's estate and issued by the Port of New York Authority (now named the Port Authority of New York and New Jersey) (the "*Port Authority*"), which was created as a body corporate and politic by a compact between the states of New York and New Jersey. The compact was approved by Congress, which granted the Port Authority the power to build, own, and operate terminals, bridges, tunnels, and other transportation facilities to facilitate transportation by land, water and air. The governing board of the Port Authority was appointed equally by the Governors of both states and its assets revert to the states upon dissolution. Each Governor has the right to veto any action of the Board of the Port Authority. Although *Shamberg* is best known for articulating the three sovereign powers, the court in *Shamberg* quotes and relies on two U.S. Attorney General Opinions asserting that a political subdivision must be a public entity in addition to exercising a substantial amount of at least one of the sovereign powers. In the first U.S. Attorney General Opinion ("*1914 AG Opinion*"), Attorney General James McReynolds was asked whether a special assessment district is a "political subdivision."[8] As quoted in *Shamberg*, Attorney General James McReynolds responded by stating that:

> The term "political subdivision" is broad and comprehensive and denotes any division of the State made by the proper authorities thereof, acting within their constitutional powers, for the purpose of carrying out a portion of those functions of the State which by long usage and the inherent necessities of government have always been regarded as public. The words 'political' and 'public' are synonymous in this connection. (Dillon Municipal Corporations, 5th ed., sec. 34.) It is not necessary that such legally constituted 'division' should exercise all the functions of the State of this character. It is sufficient if it be authorized to exercise a portion of them.[9]

The court in *Shamberg* did not set forth requirements to qualify as a division and did not

[8] Attorney General McReynolds paraphrased the question as follows: "whether special assessment districts created under the laws of the several States for the purpose of the improvement of streets and public highways, the provision of sewerage, gas, light, and the reclamation, drainage, or irrigation of considerable bodies of land within the same are 'political subdivisions' of the State within the meaning of the above proviso [the exemption from tax under the 1913 act]."

[9] 144 F.2d 998, at 1021. 30 Op. Atty. Gen. 252, 253 (1914).

address either control by a governmental unit or accountability to the general electorate. Rather, it provides that so long as a state, acting within its constitutional powers, delegates substantial sovereign power, the division will qualify as a political subdivision. The 1914 AG Opinion, as well as *Shamberg*, expressly state that what constitutes a division is "any division' made by proper authorities, acting within their constitutional powers, for the purpose of carrying out a portion of those functions of the state which by long usage and the inherent necessities of government have always been regarded as public." This legal view demonstrates significant deference to states and localities in determining what will qualify as a division so long as functions that traditionally have been regarded as public are carried out.

The 1914 AG Opinion applies the test for "political subdivision" to a special assessment district by looking at whether the district's functions are "public." *Shamberg* cites language stating that the "words 'political' and 'public' are synonymous" and that an entity is a political subdivision if it exercises "public functions,"[10] even if it did not have each of the three enumerated sovereign powers.[11] This language is the basis for determining if the entity is furthering a public purpose.

B. Seagrave Corporation

In *Seagrave Corporation v. Commissioner*,[12] the Tax Court considered whether private, nonprofit corporations, established under general incorporation laws of various states, for the purpose of operating volunteer fire companies, qualified as political subdivisions of the respective states for purposes of the exclusion of interest from federal income tax on debt issued by such corporations.

The Tax Court held that the corporations are not political subdivisions and stated as follows:

> They may be political, in the sense that 'political' is synonymous with 'public,' but they are not subdivisions of the State. It may be conceded the volunteer fire companies perform a public function in the sense that they perform the same function that is generally carried on by municipal fire departments. But the volunteer fire companies here involved are not in any sense subdivisions of the States where they are located. They were not created by any special statutes and they received no delegation of any part of the State's power. It is not enough that they perform a public service. They cannot be called a subdivision of the State unless there has been a delegation to them of some functions of local government.
>
> The volunteer fire companies were all formed under general incorporation laws of the various states. They do not render services prescribed by law. They perform services prescribed by their constitutions and bylaws as do any other corporations

[10] 1914 AG Opinion at 253 ("If, then, the special assessment districts to which you refer be lawfully created by a State for the purpose of exercising a portion of its public functions so defined, they are 'political subdivisions thereof.'")

[11] *Id.* ("It is not necessary that such legally constituted 'division' should exercise all the functions of the State of this character. It is sufficient if it be authorized to exercise a portion of them.")

[12] 38 T.C. 247 (1962) ("*Seagrave*").

> created under the general incorporation laws of the State. The fact that they were created by virtue of and in compliance with general incorporation laws does not mean they are clothed with any state power.
>
> The relations between the fire companies and the municipalities they serve are purely voluntary. No power of the State could compel them to render any services and the State, or its political subdivision, the municipality, could not be compelled to accept their services. They are free associations created by the voluntary acts of their incorporators, and not by any legislative action. They can be dissolved at the will of the corporate members.
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> Petitioner refers us to State statutes providing city, State, and county funds may or shall be contributed to support volunteer fire companies; State statutes granting exemptions from State property and excise taxes; and State statutes providing for instruction of volunteer firemen at State expense. Such statutes do not add up to any delegation of any part of State authority. All that such statutes do is recognize such companies perform a public function and should be encouraged by grants of financial aid and State tax exemptions.

Seagrave shows that there are limitations to what type of entity will qualify as a subdivision of a state, *i.e.*, entities formed under a state's general nonprofit corporation law will not qualify, even if intended to serve a public purpose. However, nowhere does the court suggest that factors such as control, or accountability to the general public (except in the sense of being able to be compelled to act), are requirements to qualify as a political subdivision. The case simply stands for the proposition that a nonprofit corporation will not qualify as a subdivision of a state where, even though performing functions of a public nature, it is formed voluntarily under the general incorporation laws, is not compelled by law to render any services, and can be dissolved at the will of the corporate members.

C. Philadelphia National Bank

Philadelphia National Bank and Philadelphia National Corporation v. United States of America,[13] considered whether Temple University ("*Temple University*" or the "*University*"), a state-related school in Pennsylvania, is a political subdivision of the Commonwealth of Pennsylvania (the "*Commonwealth of Pennsylvania*" or the "*Commonwealth*") or whether the obligations issued by Temple University could be treated as issued on behalf of the Commonwealth of Pennsylvania.

Temple University had close ties with and was dependent upon the Commonwealth of Pennsylvania, but no delegation of essential governmental functions occurred. The Board of Trustees included 39 members: three Commonwealth of Pennsylvania ex-officio members (Governor, Secretary of Education and Mayor of Philadelphia); 12 members appointed by the Governor, President of the Senate and Speaker of the House; and 24 private citizens elected by the board of trustees ("leaving the majority of non-public trustees with the power to manage and control the university"). The University was subject to limited audit of expenditures by the

[13] 666 F2d 834 (3d. Cir. 1981) ("*Philadelphia National Bank*").

Commonwealth Auditor General and the president of the school was required to make annual reports to the Commonwealth legislature. The Commonwealth General Assembly was permitted to set tuition rates if it made adequate appropriations, otherwise the management and control of University affairs are conducted by the board of trustees. The Commonwealth was allowed to provide facilities for the University.

Philadelphia National Bank (the "*Bank*") sued for a refund of taxes paid on interest received from loans to Temple University contending that Temple University is a political subdivision. The district court concluded that the University was a political subdivision and issued debt on behalf of the Commonwealth. On appeal, the U.S. argued that the University was not delegated sovereign power.

The circuit court stated that the University could obtain exemption if it were deemed a political subdivision or if it issued obligations "on behalf of" the Commonwealth of Pennsylvania. The court noted that there is "surprisingly little decisional law on what constitutes a political subdivision within the meaning of section 103 and notes that 'the leading - and almost only - cases on point' are *Shamberg* and *White's Estate*."

The court noted that "the method utilized by the legislature to establish a state relationship with Temple [University] is unique and the resulting body is not the same as a traditional authority or political subdivision." The court compared and contrasted the characteristics of Temple University to the facts of each of *Shamberg* and *White's Estate.* The court also stated that because the case must be resolved in the context of the Code, it was necessary to evaluate the delegation of state sovereignty discussed in *Shamberg* and *White's Estate*. The court concluded its political subdivision analysis by stating that "[a]t most, the university has been given a limited authorization to exercise one small aspect of the police power - one that has been delegated to private organizations as well. With such a minimal grant of police power, and with no eminent domain or taxing power, Temple [University] cannot be said to be a political subdivision." The court did not state that the political subdivision test includes an "accountability to the general electorate" requirement.

The court next considered whether the obligations issued by Temple University were issued "on behalf of" the Commonwealth of Pennsylvania. The court cited *White's Estate* for alter ego principles, and cited Regulation section 1.103-1 relating to obligations issued "on behalf of" a state or local governmental unit by constituted authorities. It then stated that a constituted authority is a wholly owned governmentally controlled entity, performing a wholly governmental function, [that] is created to be in effect the alter ego of the governmental unit. The court further stated that:

> [n]o such identity, control, or intent, however, exists between Temple [University] and the Commonwealth of Pennsylvania. Nor is there any language in the Commonwealth Act that purports to make Temple the alter ego of the state. The wording of the statute itself and the opinion of the Pennsylvania Supreme Court in Mooney make that apparent. We cannot say, therefore, that Temple [University] issued its obligations "on behalf of" the Commonwealth of Pennsylvania."

For on-behalf-of issuer status, it must be shown that the entity rises to the level of an

"alter ego" of the state, for which purpose identity of interest, control and intent are relevant. The lack of control by the Commonwealth of Pennsylvania over Temple was one of the grounds for concluding that Temple's obligations were not issued on behalf of the Commonwealth.

Although the court addressed control, it did so only in connection with on-behalf-of status, which became relevant only after the court had concluded that Temple University was not itself a political subdivision of the Commonwealth of Pennsylvania. Importantly, the *Philadelphia National Bank* court did not find it necessary to address the issue of Temple University's governing board control in its analysis of the elements required to be a political subdivision.

D. Revenue Ruling 59-373

Rev. Rul. 59-373,[14] considered whether a soil conservation district created under the Colorado Soil Conservation Act qualified as a political subdivision. The analysis of the Service is as follows:

> For the purpose of section 103 of the Code, it has been held that divisions of a state which are formed to achieve a recognized public purpose and whose revenue and assets inure only to the benefit of the state constitute political subdivisions of the state even though the sovereign powers delegated to the division are limited in degree (citations omitted).
>
> In the instant case, the soil conservation districts of the State of Colorado are created to carry out a recognized public purpose and are vested in this regard with limited rule making and taxing powers. Prior to their dissolution, their revenues and assets are available only for the purpose of carrying out soil conservation programs and, upon dissolution, the assets of a conservation district are sold and the net proceeds are deposited with the State Treasurer to the credit of the state board to defray the costs of establishing other soil conservation districts. If at any time after such fund is established there shall be no soil conservation districts in existence in the state, then any balance remaining in the state fund shall be transferred to the general fund of the State.
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> Accordingly, it is held that soil conservation districts created under the laws of the State of Colorado constitute political subdivisions of that State within the meaning of section 103 of the Code. Therefore, interest on obligations issued by such districts is excludable from gross income of recipients thereof in computing their Federal income tax liabilities.

Rev. Rul. 59-373 demonstrates the facts and circumstances nature of political subdivision status. A facts and circumstances analysis is appropriate because the governmental purposes to be achieved by any particular entity will vary significantly across political subdivisions and the types of sovereign power (tax, police and eminent domain) needed to achieve the governmental purposes will vary from case-to-case. States would presumably wish to be careful not to

[14] 1952-2 C.B. 37.

delegate more sovereign powers than are necessary to achieve the desired governmental purpose.

Despite limited rule making and taxing power, the soil conservation district in Rev. Rul. 59-373 was determined to be a political subdivision, implying that "weak" sovereign powers can be shored up with strong control and historic public purposes.[15]

E. Revenue Ruling 73-563

Rev. Rul. 73-563,[16] addressed whether a rapid transit authority (the "*RTA*") qualified as a political subdivision of a state. The RTA, a public corporation, was created by an act of the state legislature to plan, acquire, finance, maintain and administer a rapid transit system within a specific geographic area encompassing several participating counties. The development of a mass transit system by the RTA was declared to be an essential governmental function by the state constitution. The governing body of the RTA was the board of directors comprised of members appointed by each of the participating local governmental bodies.

Rev. Rul. 73-563 states the following with regard to the standard for being a political subdivision for purposes of issuing tax exempt bonds:

> Section 1.103-1 of the Income Tax Regulations provides, in part, that the term "political subdivision" denotes 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.
>
> Three generally recognized sovereign powers of states are the police power, the power to tax, and the power of eminent domain (citations omitted).

The RTA was not authorized to exercise directly the power to tax and the power of eminent domain. Instead, the state legislature conferred the benefit of such powers on the authority by providing channels through which such powers may be exercised by the participating local governmental bodies to assist the authority. The authority had the power to set rates, determine routes, and enforce its regulations by maintaining a security force and was, thus, considered to possess police powers. The ruling found that the authority was granted a sufficient portion of the sovereign powers of the state to perform the essential governmental function for which it was created and concluded that the authority qualifies as a political subdivision of the state within the meaning of Regulation section 1.103-1.

F. Revenue Rulings 77-164 and 77-165

Rev. Rul. 77-164,[17] considered whether a community development authority (the "*CDA*") created by the legislature of a state qualified as a political subdivision within the meaning of

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[15] *See GCM 36994* (sovereign power can exist "in a minor degree" but all facts and circumstances must be considered including public purpose and control). Additionally, the Service noted that a majority of the governing board of the soil conservation district was elected by landowners in the district with no discussion of how many landowners were necessary to constitute a "general electorate."

[16] 1973-2 C.B. 24.

[17] 1977-1 C.B. 20.

Regulation section 1.103-1(b). The CDA was created under state laws, which allowed a private developer to petition a county to establish a CDA within a county for purposes of encouraging and overseeing the orderly development of a new community. Under the state law, the CDA had the power to impose, collect and receive service and user fees and other charges to cover the costs of carrying out the purpose of developing new communities by three methods: an income charge, a flat fee, or a valuation charge. Such fees were to be used for the construction, operation and maintenance of community buildings, recreation facilities, streets, lighting, and other capital improvements that would benefit the property owners. The CDA was also empowered to enter into agreements with the county whereby the county could, in its discretion, acquire property by eminent domain for the CDA. State laws provided that the CDA had no power or authority over (1) zoning or subdivision regulation, (2) fire or police protection, or (3) water supply or sewage treatment and disposal unless such services could not be obtained from existing political subdivisions. The CDA had the power to adopt and enforce rules as to the use of community facilities, but such power did not invalidate the exercise of police power by a municipal corporation. The exercise of police power by a municipal corporation would prevail in the case of a conflict of powers exercised by both the CDA and the applicable municipal corporation.

Rev. Rul. 77-165,[18] considered whether a certain state university qualified as a political subdivision within the meaning of Regulation section 1.103-1(b). The university was established under state law and supported by legislative appropriations from general funds. The state university was authorized to create a police force for the purpose of regulating traffic, motor vehicles and speed limits only on its campus and to issue citations, impose fines, and arrest persons for the purpose of detaining them until the city police arrived. Under state law, the legislature was permitted to make limited and specific delegations of the state's power of eminent domain to the university by passing specific legislation stating the purpose for which exercise of the power by the university was restricted. Several delegations had been made for purposes such as acquiring a residence hall and a university dining hall.

Both revenue rulings set forth the following language to be used as the standard for being a political subdivision for purposes of issuing tax exempt bonds:

> Section 1.103-1(b) of the regulations provides, in part, that the term "political subdivision" denotes any division of any state or local governmental unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit.
>
> Three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the police power (citations omitted). 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. *All of the facts and circumstances must be taken into consideration, including the public purposes of the entity and its control by a government.* (emphasis added)

Rev. Rul. 77-164 concluded that (1) the CDA's power to impose and collect service and

[18] 1977-1 C.B. 21.

user fees was not analogous to the power to tax, (2) the CDA was not vested with any power of eminent domain, and (3) the CDA did not possess police power, and concluded that the CDA did not qualify as a political subdivision within the meaning of Regulation section 1.103-1(b). GCM 36994, which reviewed the revenue rulings prior to their release, specifically considered restrictions placed on sovereign powers and stated that the critical inquiry is not whether the power is somewhat restricted but whether the actual power exists.

Rev. Rul. 77-165 concluded that (1) support by legislative appropriations was not the equivalent of the exercise of the power of taxation, (2) the right to exercise the power of eminent domain in specific projects designated by the legislature did not represent a substantial right to exercise the power of eminent domain, and (3) the limited power of regulating traffic within its confines and a limited arrest power are not a delegation of a substantial police power. Accordingly, the state university did not qualify as a political subdivision.

These rulings appear to be the first time that the Service specifically stated that all the facts and circumstances must be taken into account and mentioned as such circumstances "public purpose" and "control by a government." The context in which the statement was made is very important. The context indicates that all facts and circumstances are to be taken into account *in determining whether the entity has adequate sovereign power*. The context does not suggest that either public purpose or control by a government is a requirement of political subdivision status independent of the inquiry into sovereign power. Furthermore, none of the authorities that we have reviewed indicate that control is a requirement independent of such inquiry.

The notion that public purpose and control are part of the facts and circumstances when determining if the entity has sufficient sovereign power, and that control and public purpose are not independent requirements, is further captured in the language of GCM 36994, which reviewed and analyzed Rev. Rul. 77-164 and Rev. Rul. 77-165 prior to the revenue rulings being finalized. GCM 36994 states as follows:

> The definition provided in Treas. Reg. § 1.103-1(b) has been construed, clarified and acknowledged in a significant number of cases and rulings (citations omitted). Though the concept of "sovereign power" has not been conclusively defined and the required quantity of such power has not been specified with numerical accuracy, the meaning of "part of the sovereign power" of the state, as used in Treas. Reg. § 1.103-1(b), is well understood. "Sovereign power" has been recognized, in general, to include "the powers of taxation and eminent domain and the police power." G.C.M. 36832 at 7. An entity need not possess all three of those powers, but whatever powers the entity does possess must be substantial in their effect, as are the enumerated powers, as well as in amount. See *Commissioner v. Shamberg's Estate* …. 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 (See Rev. Rul. 71-485)…

GCM 36994 further states that "we consider the meaning of 'political subdivision' for purposes of ection 103(a)(1), to be well settled." Nowhere does either revenue ruling or the GCM indicate that control or public purpose are stand-alone requirements. The sentence that mentions "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" addresses whether the entity has sufficient enumerated sovereign powers. If either control or public purpose was intended as a requirement independent of the sovereign power inquiry, GCM 36994 would have provided a discussion on control and public purpose, particularly in light of the fact that prior authorities did not mention control and public purpose as independent requirements. Significantly, neither ruling discussed how the governing board of the entity in question was selected or made any reference to a general electorate as a necessary factor.

III. ANALYSIS

A. Introduction

This section first provides a brief summary of Rev. Rul. 83-131 and shows that reliance on Rev. Rul. 83-131 in the 2013 TAM is misplaced. Second, the section sets forth why the Service should rely exclusively on authorities (cases and revenue rulings) addressing political subdivision status in the tax advantaged bond area. Third, we address considerations pertinent to potential new regulations addressing political subdivision: public purpose, division status, and control.

B. Rev. Rul. 83-131

Rev. Rul. 83-131 reversed a prior revenue ruling which held that certain North Carolina electric and telephone membership corporations qualified as political subdivisions for purposes of excise tax exemptions.

Rev. Rul. 83-131 essentially has four conclusions: (1) "the [membership] corporations … are not divisions of a state or local government unit but are financially autonomous and not controlled by a state or local government," (2) "the [membership] corporations do not have sufficient sovereign power to qualify as political subdivisions," (3) because "the membership corporations are not controlled directly or indirectly by a state or local government [, but instead,] the business and affairs of the corporations are controlled by a board of directors that is independent of such authority," the membership corporations do not qualify for the excise tax exception based on control by an agency of a state or local government, and (4) the membership corporations do not satisfy the excise tax exception for organizations performing a traditional governmental function on a nonprofit basis" because "neither providing electric services nor providing telephone services is a traditional governmental function because electric and telephone services are not generally provided by state or local governments directly."

The thinking of the Service on "division" and control notions is apparent from the following two statements in GCM 37629 (July 31, 1978), which addressed political subdivision status in a draft of the revenue ruling prior to its release.[19]

[19] GCM 38659 (March 19, 1981) also evaluated a draft of the Rev. Rul. 83-131 prior to it being finalized, although

> The electric membership corporations also fail to meet the definition of political subdivision on the ground that they are not a "division" of [a state or local governmental unit]. The electric corporations are organized and operated by their user members for their own benefit and without assistance from any state or local governmental unit. The absence of stringent control of the electric corporations by a government and the corporations' lack of public purposes afford further proof that the electric corporations are not political subdivisions.
>
> …
>
> We would also take issue with designating the telephone [membership] corporations as 'divisions' of the state …. The telephone corporations are organized and controlled by their user members and managed by a board of directors. They are financially autonomous and their operations are solely for the benefit of their own members. Therefore, the corporations are neither sufficiently controlled by a government nor motivated by wholly public purposes. As a result, the telephone corporations are not political subdivisions. (emphasis added)

In support of its ruling that the Issuer is not a political subdivision for tax exempt bond purposes, the 2013 TAM presumably relied on the following passage from Rev. Rul. 83-131, which addressed the control issue and held that the membership corporations in Rev. Rul. 83-131 were not divisions of a state or local governmental unit:

> [T]he corporations in the present case are not divisions of a state or local government unit but are financially autonomous and not controlled by a state or local government. Also, they are not motivated by wholly public purposes.

Thus, the Service concluded in Rev. Rul. 83-131 and GCM 37629 that the membership corporations were not divisions of the state of North Carolina. The above quoted language of GCM 37629 shows that the concern of the Service in Rev. Rul. 83-131was a lack of control by a governmental unit, and the ability of the district to operate for the benefit of the controlling members of the Issuer rather than for "wholly public purposes."[20] Recognizing that the GCMs

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GCM 38659 only addressed exclusive use excise tax exemptions. While General Counsel Memoranda provide the rationale behind administrative ruling, they are not legal precedent, and are infrequently reviewed when evaluating issues such as political subdivision status. See http://www.irs.gov/uac/General-Counsel-Memoranda. Accordingly, much of the practicing bar may not even be aware of the language from GCM 37629 and GCM 38659 quoted herein.

[20] Additionally, there are significant factual differences between the 2013 TAM and Rev. Rul. 83-131. Unlike the entities in GCM 37629 and Rev. Rul. 83-131, the entity in the 2013 TAM was not a membership corporation but instead was a community development district formed under a specific state statute as a governmental entity for state law purposes and controlled by a governing board elected in the district pursuant to a statutory mandated election process. Further, on dissolution of the membership corporations in Rev. Rul 83-131, any assets remaining after payment of debts were to be distributed among members of the corporations. Rev. Rul. 83-131 in fact revoked Rev. Rul. 57-193, in part, on this basis, i.e., a prior version of the North Carolina statute provided for distribution of assets to the state on dissolution. In the 2013 TAM, on dissolution, assets remaining after payment of debts were to be distributed to a local government or political subdivision. Under the facts of the GCM, the entities in question were membership corporations organized and operated by their user members for their own purpose and GCM 37629 stated that the absence of control of the *membership corporations* and a lack of public purpose *were evidence* that

are not authority, we believe that they nevertheless provide useful perspective in this regard.

After concluding that such membership corporations were not divisions of a state or local governmental unit, Rev. Rul. 83-131 inquired whether the membership corporations would nevertheless be eligible for excise tax exemptions because sales "could be considered to be made for the exclusive use of a state or local government." While explaining the application of "exclusive use of a state or local government exception" to the facts of the electric and telephone membership corporations," Rev. Rul. 83-131 set forth the language actually quoted in the 2013 TAM, *i.e.*, that the corporations are not "controlled, directly or indirectly, by a state or local government [but rather], the business and affairs of the corporations are controlled by a board of directors that is independent of such authority" and concluded that the membership corporations were not so controlled by a state or local government. Thus, the language of Rev. Rul. 83-131 that is quoted from and relied on in the 2013 TAM is not part of the analysis of Rev. Rul. 83-131 that was used to determine the political subdivision status of the corporations. Instead, it addressed one of the excise tax exceptions.

Further, Rev. Rul. 83-131 does not provide support for the accountability to a general electorate requirement set forth in the 2013 TAM. Neither the language of Rev. Rul. 83-131, nor the related GCM, address the criteria set forth in the 2013 TAM, *i.e.*, the requirement of inherent accountability, directly or indirectly, to a general public electorate; appropriate safeguards to prevent a private entity from determining how the bond subsidy should be used; and a general public to which the general electorate is responsible. If these additional requirements are to be imposed, they should be developed through a process whereby the public is provided an opportunity to comment.

C. Relevant Authorities for Definition of "Political Subdivision"

Rev. Rul. 77-143 and 78-276 state that term "political subdivision" has been defined consistently for all federal tax purposes as denoting either a division of a state or local government that is a municipal corporation or a division of such state or local government that has been delegated the right to exercise sovereign power.

While the notion of a consistent definition may have been accurate at some point in time, the Committee believes that the use of authorities addressing "on behalf of" issuer status, excise tax exemptions, and section 115 obfuscate the analysis. This is because political subdivision status, "on behalf of" issuer status, excise taxes exemptions, and section 115 are often considered at the same time. While control is an important consideration with respect to "on behalf of" issuer status, excise tax exemptions, and section 115 status, it is not a specific requirement applicable to political subdivision status.

Such confusion is illustrated in the 2013 TAM and the *Philadelphia National Bank* case. The 2013 TAM quotes language from Rev. Rul. 83-131 for control notions that is applicable to specific excise tax exemptions that have no bearing on the status of the issuer as a political subdivision. The *Philadelphia National Bank* case analyzes control of Temple University with

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the entity does not qualify as a political subdivision. Neither Rev. Rul. 83-131 nor GCM 37629 stated that control is a requirement to qualify as a political subdivision.

respect to on behalf of issuer status but not with respect to political subdivision status. To avoid confusion, when issuing further guidance on the definition of political subdivision for purposes of tax-advantaged debt, the Committee recommends that Treasury and the Service should rely exclusively on case law and rulings relating to the issuance of tax exempt financings (*i.e.*, the precedents discussed above) and that the regulations carefully differentiate between political subdivision status and other legal statuses (*e.g.*, "on behalf of," integral parts, and section 115 statuses).

D. Public Purpose Considerations

To qualify as a political subdivision, an entity must further a recognized public purpose. The 1914 AG Opinion language cited by *Shamberg* states that the entity needs to have been created:

> . . . for purposes of carrying out a portion of those functions of the State which by long usage and inherent necessities of government have always been regarded as public. The words 'political' and 'public' are synonymous in this connection.

Similarly, *Seagrave* states that an entity "cannot be called a subdivision of the State unless there has been a "delegation [ ] of some functions of local government."

The concept of public purpose needs to be flexible as the necessities of government change over time. Public purpose is not addressed at length in this comment letter because, in our experience, political subdivision status is rarely, if ever, resolved on the basis of a lack of public purpose. However, if Treasury and the Service plan to further define or explain what constitutes a public purpose, any developments on this point should be addressed through proposed regulations and, although the federal government would bear the cost, consideration could be given to allowing significant discretion to state and local governments to determine what constitutes a public purpose.

E. "Division" Considerations

The last hundred years have shown that a narrow or strict approach to determining when an entity qualifies as a political subdivision is unworkable to achieve the administration of state and local governments. Generally, division status has been found where proper authorities of a state, acting within their constitutional powers, provide for a delegation of some of their governmental functions and sufficient sovereign powers. Nowhere in the leading authorities or the regulations is it suggested that accountability to the general public is a requirement to qualify as a political subdivision. As stated above, Regulation section 1.103-1(b) simply states that a political subdivision is "any" division, provided that there is sufficient sovereign power. Regulation section 1.103-1 does not specify any requirements needed to qualify as a "division," or "political subdivision."

The most specific precedent for what constitutes a division is the language set forth in *Shamberg* and the 1914 AG Opinion, which both state that:

> the term "political subdivision" is broad and comprehensive and denotes *any* division of the State made by the proper authorities thereof, acting within their

> constitutional powers, for the purpose of carrying out a portion of those functions of the State….

This language has been in place for more than 100 years. The 1914 AG Opinion is dated January 30, 1914 and *Shamberg*, which was decided 30 years later (August 24, 1944), goes on to state:

> The term 'political subdivision' may be used in statutes in more than one sense. It may designate a true governmental subdivision such as a county, township, etc., or, as held in the Attorney General's opinion under consideration, it may have a broader meaning, denoting any subdivision of the state created for a public purpose although authorized to exercise a portion of the sovereign power of the state only to a limited degree.

The quoted language shows that "division" is intended to have a broad meaning. The only requirements to be a "division" discussed in *Shamberg* are that the division be "created by proper authorities [of a state], acting within their constitutional powers … for the purpose of carrying out a portion of those functions of the State which by long usage and the inherent necessities of government have always been regarded as public."

The history of Regulation section 1.103-1 is set forth in Appendix II. The regulation has not changed in any significant respect from its initial adoption in 1936. Minor changes were made in 1938, 1939, 1957, 1972, and as recently as 1977. With regard to "division," the regulation states that a political subdivision is:

> 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. As thus defined, a political subdivision of any State or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

Regulation section 1.103-1 does not go as far as *Shamberg* and the 1914 AG Opinion by stating that a division must be made by the proper authorities of a state, acting within constitutional powers, for the purpose of carrying out a portion of the functions of a state. Regulation section 1.103-1 does not mention control or public purpose. The only articulated standard in the regulation is that the political division be "a division of any state or local governmental unit" and that the division be delegated the right to exercise part of the sovereign power of the governmental unit.

The Committee acknowledges that not every entity created pursuant to state law will qualify as a political subdivision. For example, in *Seagrave*, the Tax Court found that private nonprofit corporations established under the state's general incorporation statute to function as volunteer fire departments are not subdivisions despite performing public functions. The Tax Court stated that the volunteer fire companies were not in any sense subdivisions of the respective states and that they were not created by any special statutes, and that they received no

delegation of any part of the state's power. It is not enough that they perform a public service. They cannot be called a subdivision of the state if there has been no delegation to them of some functions of local government.

The Committee is not aware of any judicial precedent, regulatory proposal or other guidance, or any private letter ruling,[21] that sets forth considerations or standards for being a division of a state similar to those set forth in the 2013 TAM (*e.g.*, inherently accountable, directly or indirectly, to a general electorate; a democratic process to ensure that subsidized bond financing is used for projects which the general electorate considers appropriate state or local government purposes; safeguards to ensure that governmental units determine how the bond subsidy should be used). The Committee believes that the division language of the regulations is satisfied if the division is established by a proper authority of a state, acting within its constitutional power, for the purpose of carrying out governmental functions.

F. Control and Accountability Considerations

Accountability to a governmental unit or to a general electorate can also be thought of as "control." Under current law, control is not an independent requirement to establish political subdivision status. Neither *Shamberg* nor the 1914 AG Opinion refers to control as an independent requirement of political subdivision status. The closest notion to control is the language that provides that a division is to be "made by [ ] proper authorities acting within their constitutional powers…."

In the context of tax advantaged bonds and political subdivision status, "control" was first mentioned in Rev. Rul. 77-164 and Rev. Rul. 77-165. There was no evaluation of control of the entities under consideration (*i.e.*, the CDA in Rev. Rul. 77-164 or the university in Rev. Rul. 77-165). Additionally, control was not described as an independent requirement. When evaluating whether an entity has been granted sufficient sovereign powers, all facts and circumstances are to be considered, including control. In Rev. Rul. 59-393, despite limited rule making and taxing power, the subject soil conservation district was determined to be a political subdivision where the state had strong control and, on dissolution, all assets were to be provided to the state. Rev. Rul. 59-393 establishes that where there is a minimal delegation of sovereign power, strong control can be used to establish that an entity qualifies as a political subdivision.

In various governmental contexts, it appears that Treasury and the Service have been moving toward a requirement of control by superior governmental units. For example, in the context of whether an entity is an "instrumentality" for purposes of section 141, the Committee understands that the Service will not issue a favorable private letter ruling unless the applicant establishes control by a governmental unit. In proposed rulemaking under section 414(d), Treasury and the Service are proposing that (a) the term political subdivision of a state be defined as a regional, territorial, or local authority, such as a county or municipality (such as, a municipal corporation), that is created or recognized by state statute to exercise sovereign

[21] A discussion of private letter rulings ("*PLR*" or "*PLRs"*) issued to date on political subdivision status in these comments was considered but it was decided not to include such discussion because: (1) such rulings are based on particular facts and circumstance of a particular issuer and all relevant facts and circumstance may or may not have been mentioned in the private rulings, and (2) PLRs have no precedential value.

powers, where *the governing officers are either appointed by state officials or publicly elected*, and (b) in making the determination of whether an entity is an agency or instrumentality of a state or political subdivision of a state, a significant factor is whether the entity's governing board or body is controlled by a state (or political subdivision thereof). Importantly, the Service has repeatedly stated that section 414(d) provisions are not be applicable to the analysis under section 103.

The Committee does not advocate that control should be a separate requirement for an entity to qualify as a political subdivision. The Committee also strongly recommends against a stringent control standard. A separate control requirement must be carefully considered and developed, and Treasury and the Service need to be mindful that issuers with varying levels of control by other governmental units have been in place for long periods of time. Such issuers will need flexibility and continued access to federally subsidized financing for needed public improvements.

However, if Treasury and the Service intend control to be an independent consideration or otherwise to be developed as relevant to political subdivision status, that change should be developed in proposed regulations so that all interested parties are put on notice of any potential changes and have an opportunity to comment. Further, if control is to be developed as a consideration, the Committee believes that a facts and circumstances analysis should be used because the governmental purposes to be achieved by an issuer will vary significantly across political subdivisions, and the types of sovereign powers (tax, police and eminent domain) needed to achieve the governmental purposes will vary from case-to-case.

IV. CONCLUSION AND RECOMMENDATIONS

The legal analysis set forth in the 2013 TAM, which would impose new requirements for qualifying as a political subdivision, is not supported by judicial, regulatory or administrative precedent. Accordingly, we believe that the 2013 TAM should be withdrawn, or modified to conform with existing precedent.

While we do not comment on whether the Issuer in the 2013 TAM qualifies as a political subdivision or whether the interest on the bonds that it issued is excludable from gross income of the holders thereof, we do recommend, however, that the Service reconsider the analysis set forth in the 2013 TAM. Our concern is that the analysis used in the 2013 TAM imposes new requirements for qualifying as a political subdivision that are not supported by existing legal precedent and could call into question a variety of financing structures that have been used for many years in many states.[22]

Although the 2013 TAM cannot be used as precedent, it has been and will be reviewed

[22] In the 2013 TAM, the Service stresses that the Issuer was organized and operated to perpetuate private control by the developer and avoid responsibility to a public electorate. This language suggests that the Service was concerned with notions related to private inurement, private benefit to the developer, and private use, rather than the political subdivision status of the Issuer. These concerns may better be addressed under the private use rules rather than on the basis of whether an issuer is a political subdivision. A discussion of private use issues of the Issuer are beyond the scope of these Comments.

by practitioners and auditors alike and creates uncertainty with regard to the standard to be applied when evaluating political subdivision status. Audits of other issuers based on the additional requirements stated in the 2013 TAM would be inappropriate and costly to state and local governments. Questions also arise about the relevance and significance of the considerations in the 2013 TAM when opinions are to be issued, particularly in the context of issuing the unqualified opinions which are generally required of bond counsel in the tax exempt bond market.

Given the strong need for certainty in the tax exempt transactional practice, we also recommend that Treasury and the Service issue a Notice providing interim guidance and stating that proposed regulations will be issued providing an updated definition of political subdivision for purposes of issuing tax-advantaged bonds. Consistent with the recommendations of the House of Representatives Committee on Appropriations,[23] such a Notice should also state that any change to the definition of political subdivision will apply solely on a prospective basis. Attached in Appendix I is a suggested outline of such a Notice and several examples that might be considered for inclusion in the Notice. Should Treasury and the Service decide to pursue a proposed notice, the Committee would be pleased to further discuss these examples and any proposed analysis for the determination of whether an entity qualifies as a "division" and provide any other helpful input.

[23] H. Rep. 113-508, at 20 (2014) stated:

> *Guidance on the Definition of Political Subdivision.*--The Committee is concerned that recent actions by the IRS have caused confusion concerning the definition of a political subdivision under the tax exempt bond rules, including for entities long-recognized as political subdivisions, and have resulted in the inability to move forward with or the delay of economic development projects throughout the country. The Committee encourages the IRS to issue guidance to clarify the definition of political subdivision, to provide opportunity for public comments prior to any changes, and to make changes, if any, prospective.

APPENDIX I

Outline of Proposed Notice Addressing Definition of Political Subdivision

Purpose of the Notice

- Update published guidance with respect to the definition of the term political subdivision for purposes of section 103 (Rev. Rul. 77-164 and Rev. Rul. 77-165)
- Set forth examples (see below)

Background

- Include description of Reg. § 1.103-1 and cases and revenue ruling set forth in the Tax Exempt Financing Committee's Comments
- Describe concerns of the Service in this area
- Describe concerns of practitioners and the industry in this area (*e.g.*, concerns regarding adverse effect of the TAM on construction of traditional municipal infrastructure)
- Acknowledge market practice regarding delivery of unqualified opinions

Scope and Application

- Treasury and the Service expect to promulgate proposed regulations
- General Guidance
    - Acknowledge that there are numerous different structures for governmental units/political subdivision throughout the United States (hundreds)
    - Given the variety of structures, there is a need for a "principled approach" to establishing political subdivision status, i.e., a highly engineered approach would be inflexible and would not work
    - Totality of circumstances is to be considered
    - Consider an approach similar to Announcement of Proposed Rule Making for determining if an entity is an agency or instrumentality of a state for governmental plan (section 414(d)) purposes, i.e., look to all facts and circumstances. Two categories of factors, main factors and others factors; to be modified/refined to address relevant considerations for political subdivision status.
    - Discuss role of control and how it is established
    - Discuss "public purpose" and how it is established
    - Consider grandfathering entities in place [as of _____][for more than __ years]. Alternatively, consider grandfathering debt issued prior to the publication of Final Regulations in the Federal Register.

Examples

- Example 1 – *Special Irrigation District*. Special Irrigation District X was created pursuant to the laws of State Y to provide irrigation for the area under its jurisdiction which

encompasses a rural area with approximately 10 farms. Special Irrigation District X is governed by an independent board of directors elected by a limited number of landowners in its jurisdiction based upon acreage. Special Irrigation District X has the right to condemn property and the power to impose property taxes. Special Irrigation District X is also subject to oversight by State Y in that it must submit annual financial reports to State Y and must follow state laws pertaining to public meetings, bonded indebtedness, recordkeeping, and elections. Special Irrigation District X is a political subdivision.

- Example 2 – *Mutual Ditch Company.* Mutual Ditch Company Z was created pursuant to general non-profit cooperative corporation laws of State Y for the purpose of constructing and operating irrigation ditches to deliver irrigation water from a reservoir to farms adjacent to the ditches. Ten farms served by Z's ditches and the owners are also the owners of the rights to all of the water that flows through Z's ditches. The owners, by virtue of their ownership of the water rights to the water that flows through Z's ditches, are the members of Z, which is a membership corporation that does not issue stock. Z is governed by an independent board of directors elected by its members, each of which has a vote that is weighted according to the acre-feet of water rights owned by that member that are transported in Z's ditches. Z has the right to condemn property for the purpose of constructing, operating and maintaining its ditches. Z is not subject to any of the laws of Y that apply to governmental entities, such as open meeting laws, public records laws, laws on bonded indebtedness and laws on governmental elections. Z is however subject to the same level of supervision by the state attorney general as are other cooperative non-profit corporations. Z does not have any of the immunity from tort liability that governmental entities in Y typically have, and on dissolution, Z's assets, after all of Z's creditors are paid, are divided among Z's members, in the same proportion as that used to determine a member's weighted vote. Z is not a political subdivision because it is not a municipal corporation or a division of state or local government.

- Example 3 – *General Purpose District.* A tax district in state is formed under state statute by County approval (the "District") to provide essential governmental functions to an area within County for which development is planned by a single private developer ("D"). At the time of formation of the District and during an initial development period D is likely to be the sole property owner. D intends to proceed with all reasonable speed to develop and sell the land within the District to members of the general public for commercial use. The District, whose board is initially elected by the sole landowner, issues bonds and uses the bond proceeds to finance facilities for traditional governmental functions, including extensions of municipal water systems, street construction and paving, curbs, storm water collection, sidewalk and street-light installation, and sewage disposal. The bonds will be repaid and secured by assessments on the property. D and the District reasonably expect that property will be sold or ground leased long term to at least two unrelated parties who will become eligible to elect board members and that the board will be controlled by board members unaffiliated with the initial developer within 5 years. The District is a political subdivision because it (i) is a division of state or local government, and (ii) has been delegated more than an insubstantial amount of the power to tax.

- Example 4 – *Homeowners' Association.* Homeowner's association ("HOA") is formed under state's general non-profit cooperation laws and state's laws governing common interest communities. These laws requires the creation of associations organized under general for-

profit or non-profit corporation law to govern commonly owned areas in a common interest community and to enforce the covenants that apply to all real property within the boundaries of the common interest community by virtue of covenants, declarations and restrictions in the deeds to property in the common interest community. Each person who is an owner of property in the common interest community is a member of the HOA, but only for so long that person owns property in the common interest community. HOA provides open space and parks, a clubhouse and swimming pool, tennis courts, and limited security services to and for the benefit of the members of HOA, and their renters and guests. The HOA has no power of eminent domain. It does have the right to charge assessments against all property in the common interest community other than HOA owned property and it employs a private security service which provides guards and other safety related services to protect HOA owned property and limited security services for all property in the common interest community. HOA is subject to regulation and supervision by the state as an association governing a common interest community, which include rules about access to records, a member's right to attend meetings of the board of directors, and elections of directors and elections on changes in covenants and by-laws. These rules are not the same as the public meetings laws, public records laws and election laws applicable to governmental entities in the state, and HOA does not have any of the immunity from tort liability that governmental entities in the state typically have. On dissolution, HOA's assets, after all of HOA's creditors are paid, are divided among HOA's members. The HOA is not a political subdivision because it is not a municipal corporation or a division of state or local government and it has not been delegated more than an insubstantial amount of any of the sovereign powers of eminent domain, taxation or the police power

- Example 5 – *Commercial Development District*. (i) District X is a special district created under the constitution of State Y and specifically formed under a specific state law (the "*Act*"). The boundaries of District X are located entirely within City Z, which must consent to the creation of District X prior to any election confirming the District. The stated public purposes of District X are economic development and the expansion of commerce. The Act specifically allows District X to develop streets, water and wastewater facilities, roads, sidewalks, lighting, parking, rail and recreational facilities and other public facilities, and to finance such improvements through the issuance of bonds supported by ad valorem taxes on all property within District X if authorized by a majority of the voters. The Act may be amended by the state legislature from time to time.

  District X is expected to be a primarily commercial district. Initially, all of the property within the boundaries of District X will be owned by a single for-profit developer ("*Developer*"). As development occurs, Developer intends to sell or lease portions of the property within the District to other commercial entities unrelated to Developer, but there is no guarantee that such sales will occur or when they may occur.

  Pursuant to provisions of the Act, temporary directors are appointed by a state agency (the "*Agency*") after receiving from the owners of a majority of the assessed value of the real property within the boundaries of District X a petition naming such temporary directors. As the sole landowner in District X, the Developer named the temporary directors. Pursuant to state law, before issuing any bonds or other obligations, the temporary directors must hold an election to confirm the establishment of District X and to elect permanent directors.

  Pursuant to a valid election under state law, eligible voters in District X have authorized

the imposition of an ad valorem tax on all property owners in District X. District X is subject to state public meeting and public records laws applicable to governmental entities, and its governing body members and employees are subject to state public conflict of interest, financial reporting and disclosure and other ethics laws generally applicable to government officials and government employees. Upon dissolution, the assets of District X will be liquidated to pay its obligations, and the remainder distributed to City Z.

District X is a political subdivision because it (i) is a division of state or local government, and (ii) has been delegated more than an insubstantial amount of the power to tax.

(ii) The facts are the same as above except that eligible voters (defined under state law to be owners of property located in District X and residents of District X) are likely to be corporations and other legal entities that are not natural persons, and the number of resident voters in District X is limited and is expected to remain limited. Resident voters may have a relationship to the Developer. The fact that there will be a limited number of voters does not prevent District X from being a division of state or local government and a political subdivision.

(iii) The facts are the same as above except that in connection with the creation of District X, the voters have also authorized the issuance of bonds for the purpose of extending existing rail facilities, which are owned by a private user. The primary purpose of District X is to further economic development by extending rail facilities, which will be accomplished by granting proceeds of the bonds to a private user to build the additional rail facilities, which will be owned and operated by the private user. District X will receive no payments from such private user, and the bonds will be paid solely from the ad valorem taxes on property within District X.

The fact that District X intends to issue bonds the proceeds of which will be used for private business use that will indirectly benefit the Developer, who may exercise some level of control over the election of the board of directors, does not prevent District X from being a division of state or local government and a political subdivision.

- Example 6 – *Retail and Commercial Office District*. (i) County A determines to promote development of a blighted area located within its boundaries. In response to a request for proposals issued by County A, Developer D submits a proposal for a mixed-use office and retail development for the area. As part of the proposal, Developer D proposes the formation of District B to finance public infrastructure for the project consisting of what will be governmentally owned streets, sidewalks, streetlights, and water and sewer facilities. District B is a unit of special purpose government formed under specific state law (the "Act"). The Act authorizes the formation of special districts for the purpose of financing specified categories of infrastructure improvements through the issuance of bonds. District B is authorized to levy and collect more than an insubstantial amount of ad valorem taxes on all non-exempt real property located within District B. As required under the Act, Developer D submits a petition to County A for the formation of District B describing the proposed infrastructure improvements, the amount of bonds to be issued, and the source of repayment of the bonds. County A approves the formation of District B by legislative action. Initially, Developer D is the only property owner and the only eligible elector within District B. District B is a governmental entity under state law, *e.g.*, it is subject to public meetings and

public records laws applicable to governmental entities, its employees and officers are subject to public conflict of interest, financial reporting and disclosure, and public ethics laws applicable to public employees and officials. The election of its governing board is subject to state's general public election laws. Under the Act, District B must provide annual financial reports and audits to County A. Upon dissolution, the assets of District B will be liquidated to pay its obligations, and the remainder distributed to County A. Pursuant to the Act, the governing board of District B is elected by eligible electors of the District, consisting of owners of property in the District. District B is a political subdivision because it (i) is a division of state or local government, and (ii) has been delegated more than an insubstantial amount of the power to tax.

(ii) The result does not change if Developer D is expected to retain ownership of substantially all of the real property located in the District for the foreseeable future and to lease space to retail and business tenants.

Interim Guidance and Reliance

- Notice provides interim guidance. Issuers of tax exempt bonds may rely on the Notice for any actions taken with respect to tax exempt bonds on or before the effective date of Final Regulations under section 103 that implement the guidance in the Notice.
- Treasury and the Service may amend or supplement the guidance in this Notice as circumstances warrant.

Request for Comments

- Before any notice of proposed rulemaking is issued with respect to the guidance set forth in the Notice, consideration will be given to any written public comments on the Notice that are timely submitted.

APPENDIX II

Legislative Acts

Tariff Act of 1913, Section II (Income Tax), Paragraph B:

> That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions;[1]

Revenue Act of 1934, § 22(b)(4):

> (4) TAX-FREE INTEREST.—Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (B) obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States; or (C) the obligations of the United States or its possessions. Every person owning any of the obligations enumerated in clause (A), (B), or (C) shall, in the return required by this title, submit a statement showing number and amount of such obligations owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit) and in the case of obligations of a corporation organized under Act of Congress, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from the taxes imposed by this title;[2]

REGULATIONS

Regulations 94 (1936)[3]

> Art. 22 (b)(4)-1. *Interest upon State Obligations.* – Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term "political subdivision", within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may, for the purpose of exemption, include special assessment districts

[1] Ch. 16, 38 Stat 168 (1913).

[2] Ch. 277, 48 Stat 687 (1934).

[3] 1 Fed. Reg. 1802, 1818 (Nov. 14, 1936).

so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. (emphasis added)

26 CFR § 3.1-1 (1938):

> 3.22 (b) (4)-1 Interest upon State obligations. Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term "political subdivision," within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. (emphasis added)

Regulations 101 (1939)[4]

> ART. 22 (b) (4)-1. Interest upon State obligations. Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term "political subdivision," within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may or may not, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. (emphasis added)

[4] 4 Fed. Reg. 611, 634 (Feb 10, 1939) (emphasis added). *See also Shamberg* ("The provisions of the foregoing Article of Regulations 94 were amended in Treasury Regulations 101, promulgated under the Revenue Act of 1938 so that the words "or may not" follow the word "may" in the last sentence.").

Reg. § 1.103-1(b) (1972):[5]

> (a) Interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "State or local governmental unit") is not includable in gross income, except as provided under section 103(c) and (d) and the regulations thereunder.
>
> (b) Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit. However, section 103(a)(1) and this section do not apply to industrial development bonds except as otherwise provided in section 103(c). See section 103(c) and §§1.103-7 through 1.103-12 for the rules concerning interest paid on industrial development bonds. See section 103(d) for rules concerning interest paid on arbitrage bonds. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. <u>The term "political subdivision," for purposes of this section denotes 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</u>. As thus defined, a political subdivision of any State or local governmental unit <u>may or may not</u>, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit. (emphasis added)

[5] T.D. 6220, 25 Fed. Reg. 11,402 (1956) (as amended by T.D. 7199, 37 Fed. Reg. 15,486 (1972)).