



Public Finance/Federal Tax ADVISORY ■

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The Far Unlit Unknown—The IRS Seeks to Define “Political Subdivision”

On February 23, 2016, the Internal Revenue Service (IRS) released [proposed regulations](#) providing guidance on the definition of a “political subdivision” under the tax-exempt bond rules. A public hearing is scheduled for June 6, 2016, with a submission date of May 23, 2016, for comments.

If finalized as drafted, the proposed regulations would inject significant uncertainty into many tax-exempt financing transactions and potentially have a material impact on the structure and operations of many joint action agencies, state and local authorities, and other government entities that currently may issue tax-exempt bonds.

Background

Section 103 of the Internal Revenue Code provides that gross income does not include interest on “any State or local bond,” which includes “an obligation of a State or political subdivision thereof.” Current Treasury regulations define “political subdivision” 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.”

Courts and the IRS have tried to clarify this opaque definition in cases such as *Comm’r v. Shamberg’s Estate* and *Philadelphia Nat’l Bank v. United States* and revenue rulings such as Rev. Rul. 78-276 and Rev. Rul. 83-131.

More recently, the IRS issued guidance in [Technical Advice Memorandum \(TAM\) 201334038](#), which may have served, in part, as the impetus for issuing the proposed regulations. In the TAM, the IRS ruled that a community development district (CDD) that gave a private developer and several of his family members near total control over bond proceeds did not qualify as a political subdivision because the CDD failed to “demonstrate that it [was] a division of a state or local government.”

The TAM states that Section 103 requires the “democratic process” to ensure subsidized bond financing goes to projects benefiting the general electorate. Accordingly, the TAM concludes Section 103 cannot be satisfied if a private entity can determine how the bond subsidy is to be used, particularly when the entity is “organized and operated in a manner intended to perpetuate private control and to avoid [indefinite] responsibility to a public electorate.”

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Summary of the Proposed Regulations

To ensure the appropriate safeguards are in place, the proposed regulations set forth a three-factor test that entities would be required to satisfy in order to be considered a political subdivision of a state or local government:

- **Sovereign Powers** – The entity must have a “delegated right” pursuant to state or local law to exercise at least one of the three recognized sovereign powers, namely, the power of taxation, the power of eminent domain or police power.
- **Governmental Purpose** – The entity must serve a “governmental purpose,” which is satisfied through the following: (1) enabling legislation that sets forth a public purpose; (2) the fulfillment of that public purpose by the entity; and (3) the entity must operate in a manner that provides a significant public benefit with no more than an incidental benefit to private persons.
- **Governmental Control** – In this most significant test, a state or local governmental unit must exercise control over the entity by having a substantial amount of each of the sovereign powers and acting through its governing body or duly authorized elected officials in their official capacities. Control requires an “ongoing right or power to direct significant actions of the entity,” including the rights to approve or remove a majority of the entity’s governing body, to elect a majority of the entity’s governing body through periodic elections, and to approve or direct significant uses of the entity’s funds or assets.

Furthermore, control must be properly vested in a state or local governmental unit or an electorate established by state or local law that is not itself a “private faction.” Private factions exist if control can be exercised by “the votes of an unreasonably small number of private persons.” The proposed regulations provide a safe harbor that no private faction will exist if the voting power required to exercise control is dispersed over more than 10 people.

Effective Dates

The proposed regulations would generally apply to all entities for all purposes of the tax-exempt bond provisions beginning 90 days after the proposed regulations are finalized. However, the IRS has also provided a transition rule whereby the new definition of “political subdivision” would not apply for three years and 90 days after the proposed regulations are finalized, but only for entities in existence 30 days before the proposed regulations are finalized. This may provide entities some much needed time to restructure in order to satisfy the new definition while allowing them to continue to issue new bonds during the transition period.

Implications

The proposed regulations inject significant uncertainty for issuers and their advisors. While the sovereign powers test is a restatement of a long-established requirement for political subdivisions, the governmental purpose and governmental control tests present significant challenges for tax-exempt financing transactions.

For example, under the governmental purpose test there is no clear standard in the proposed regulations on what it means to “operate in a manner that provides a significant public benefit” or what constitutes an “incidental private benefit.” The proposed regulations appear to import concepts found elsewhere in the Internal Revenue Code but only serve to confuse the requirements under Section 103.

More troubling is the governmental control test, which raises a number of material issues. According to IRS representatives, the new governmental control test is designed to be objective; however, the proposed regulations as drafted are less than clear. State statutes provide various organizational structures for entities, including the appointment and governance of their boards. Whether a state or local government or an electorate is exercising the proper degree of control pursuant to the regulations will not necessarily be a straightforward determination.

In many instances, the issue will be whether control is properly vested in a state or local government or an electorate, and whether such control is exercised on an ongoing basis. For example, how should entities that are themselves governed by political subdivisions be treated under the proposed regulations? Is control vested in a state or local government when control may be tiered through other entities? Additionally, for purposes of determining whether a private faction exists, what does “unreasonably small” mean? As drafted, the regulations raise these and many other issues.

The IRS can anticipate receiving many comments concerning the proposed regulations, but it is uncertain what changes may be made before final regulations are issued. Issuers interested in shaping the final regulations should take the opportunity to submit public comments while time remains.

If you have questions concerning the proposed regulations or are interested in submitting comments, please contact [Peter Floyd](#) at 404.881.4510, [Glenn Thomson](#) at 404.881.7561, [Scott Harty](#) at 404.881.7867, [Amber Pelot](#) at 404.881.7528 or Mark Moore at 404.881.4954.

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ■ 5th Floor ■ East Palo Alto, California, USA, 94303-2282 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333