

# **Bond Case Briefs**

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## **NABL Seeks Guidance on Political Subdivision Question.**

Allen Robertson of the National Association of Bond Lawyers has submitted to Treasury a memorandum requesting guidance on whether an issuer with a limited number of property owners, electors, or taxpayers is a political subdivision for purposes of section 103.

November 21, 2013

Vicky Tsilas

Associate Tax Legislative Counsel

Office of the Tax Legislative Counsel

Department of the Treasury

1500 Pennsylvania Avenue, NW Room 3044

Washington DC 20220

James Polfer

Branch V Chief, Financial Institutions and Products

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Dear Ms. Tsilas and Mr. Polfer:

The National Association of Bond Lawyers ("NABL") respectfully submits the attached memorandum requesting guidance on whether an issuer with a limited number of property owners, electors or taxpayers is a political subdivision for purposes of section 103 of the Internal Revenue Code. This guidance is necessary as a result of Technical Advice Memorandum 201334038 (the "TAM"), which NABL believes is contrary to established legal authority. The TAM has had an immediate chilling effect on the issuance of tax-exempt bonds by such issuers throughout the country and has raised questions in the market about outstanding bonds of such issuers, which may result in a loss in value of those bonds for current holders. This memorandum was prepared by an ad hoc taskforce comprised of those individuals listed on Exhibit A, and was approved by the NABL Board of Directors.

NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. We respectfully provide this submission in furtherance of that mission.

If NABL can provide further assistance, please do not hesitate to contact Bill Daly in our Washington, D.C. office at (202) 503-3300.

Sincerely,

Allen K. Robertson

National Association of Bond

Lawyers

Washington, DC

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## MEMORANDUM

### GUIDANCE ON "POLITICAL SUBDIVISION"

Technical Advice Memorandum 201334038, dated August 23, 2013 (the "TAM"), has raised concerns in the bond community regarding the issuance of tax-advantaged obligations by certain issuers having a limited number of property owners, electors or taxpayers ("Districts"). The National Association of Bond Lawyers ("NABL") is concerned that the Internal Revenue Service's position in the TAM is contrary to established legal authority regarding the requirements for a District to qualify as a political subdivision and that this change has had an immediate chilling effect on the issuance of tax-exempt bonds by Districts throughout the country.

Under the traditional legal analysis that has been applied by the courts, the IRS, and practitioners for many years, the determination of whether an entity is properly considered a political subdivision for federal income tax purposes is based on whether it has been delegated the right to exercise substantial sovereign powers.<sup>1</sup> These sovereign powers include the power to tax, the power of eminent domain and the police power. A qualified issuer need not have all three powers but it must have more than an insubstantial amount of at least one of the sovereign powers.

The TAM raises serious concerns with respect to certain issuers. The TAM calls into question whether Districts with a limited number of property owners, electors or taxpayers may ever qualify as a "division of a state or local government" by asserting that "an entity that is organized and operated in a manner intended to perpetuate private control, and to avoid indefinitely responsibility to a public electorate, cannot be a political subdivision of a State," effectively requiring that the governing board of a District either be elected by a broad-based electorate or be appointed by a state or local government that is itself elected by a broad-based electorate.

#### Position in TAM Not Supported by Existing Authority.

The TAM cites Revenue Ruling 83-1312 for the proposition that an essential factor to be considered in determining whether a District is a political subdivision is whether the District is controlled by a state or local government.

The entities considered in Revenue Ruling 83-131 were North Carolina electric and telephone membership corporations that provided utility services, and the ruling addressed the applicability of an exception to the excise tax imposed on the sale or use of diesel fuel under then section 4041 of the Code. Former section 4041(g)(2) of the Code provided an exception from the diesel fuel excise tax "with respect to the sale of any liquid for the exclusive use of any State, any political subdivision

of a State, or the District of Columbia, or with respect to the use by any of the foregoing of any liquid as a fuel." The ruling stated that "the 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 a state or local government that has been delegated the right to exercise sovereign power." The ruling stated that the corporations at issue did not have the power to tax or police power, and that their power of eminent domain was significantly limited, and therefore "the corporations do not have sufficient sovereign power to qualify as political subdivisions."

Revenue Ruling 83-131 proceeded to state that "[a]lthough the corporations are not political subdivisions, they still would come within the scope of the exemption in question if sales to them could be considered to be made for the exclusive use of a state or local government." The ruling then provides that "[i]n determining whether a sale to, or use by, an organization is for the exclusive use of a state or local government, it must be established that the organization either (a) is controlled, directly or indirectly, by an agency of a state or local government, or (b) is performing a traditional governmental function on a nonprofit basis." Thus, the language in Revenue Ruling 83-131 which is the sole authority cited in the TAM for the proposition that control by a state or local government is an essential element for qualification as a political subdivision was not from the part of the ruling dealing with political subdivision status, but rather was from the part of the ruling that analyzed whether, even though the corporations were not political subdivisions, sales to such corporations might nonetheless be considered made "for the exclusive use of a state or local government." In determining that the corporations at issue were not political subdivisions, Revenue Ruling 83-131 relied exclusively on the traditional analysis described above regarding whether the corporations had been delegated authority to exercise more than an insubstantial amount of one or more of the sovereign powers.<sup>3</sup>

Not only does the lone authority cited in the TAM not support the position asserted in the TAM as described above, we are aware of no other authority supporting the proposition that a District having a limited number of property owners, electors or taxpayers cannot qualify as a political subdivision. In fact, such a proposition is contrary to other precedents in which Districts were respected notwithstanding the fact that all or substantially all of the property in the District is owned by a single landowner (or related landowners). In *Commissioner v. Birch Ranch & Oil Co.*, 192 F.2d 924 (9th Cir. 1951), the court held that the taxpayer was entitled to deduct payments made to a District, stating:

Since the district met the requirements of California law, its status as a district entity, not to be confused with the owners of the ranch, or the taxpayer-corporation, cannot be questioned regardless of the fact that the district served but a single ranch, (plus one 240 acre parcel). The western states have long considered that the reclamation, even of a single parcel of land in a single ownership, may justify the exercise of sovereign powers. Here the power afforded is that of taxation.

*Id.* at 928. Similarly, in *Rutland v. Tomlinson*, 63-1 U.S.T.C. ¶ 9173 (DC. Fla. 1963), the court upheld the taxpayer's deductions for taxes paid to a District in which the taxpayer owned approximately 95 percent of the land comprising the District. See also Rev. Rul. 76-45, 1976-1 C.B. 54 (holding that taxes imposed by a District formed and controlled by a single taxpayer are deductible to the extent allocable to maintenance or interest charges).

It also should be noted that in Announcement 2011-78, 2011-51 I.R.B. 874, in an advance notice of proposed rulemaking relating to governmental employee benefit plans under section 414 of the Code, the IRS proposed a definition of political subdivision that included a requirement that the governing officers of the entity be either appointed by State officials or publicly elected. The Announcement acknowledged that the term "political subdivision" is also used for other purposes of the Code, and provided that the proposed definition would not apply for any other purposes of the

Code, with a specific reference to section 103 of the Code, thus recognizing that the proposed definition in the Announcement would be contrary to existing authority under section 103 and should not be applied for purposes of section 103.

### IRS Concern over Private Entities

It appears that the principal concern of the IRS underlying the analysis set forth in the TAM is the possibility that a non-governmental entity could assert political subdivision status solely by reason of being delegated a limited right to exercise sovereign power. The IRS states in the TAM that “the mere delegation of sovereign power is not sufficient to create a political subdivision. If it were sufficient, then a clearly private entity with powers of eminent domain, including some railroads and utilities, could issue bonds without any political oversight.”

While we appreciate the IRS’s concern regarding private entities asserting the ability to issue tax-exempt bonds, a number of factors make the typical District clearly distinguishable from such private entities. Districts typically are formed under specific state statutes containing detailed requirements regarding how a District must be formed, the powers a District may exercise, the activities a District may undertake, how a District’s governing body is elected or appointed, and disposition of the District’s assets upon dissolution. Moreover, under applicable governing statutes, formation and operation of a District may also involve state or local government approval of a service or business plan, intergovernmental agreements relating to the provision of facilities and services, approval of property platting, permitting and/or licensing, oversight of finances and operations through required periodic reporting, a contribution of funds to the financing by a state or local governmental unit, and judicial validation of the entity’s creation and/or issuance of its debt. In addition, state law often provides that Districts are considered political subdivisions and/or governmental entities for state law purposes, resulting in the District being subject to numerous state law requirements generally applicable to governmental entities, such as open meeting and public records laws, requirements to adopt a budget and conduct an audit, governing body members being subject to conflict of interest and disclosure laws, and governing body members or employees being treated as governmental/public officials or employees.

Thus, under State law, the typical District is subject to substantial controls over its formation and operation, and is subject to numerous requirements generally applicable to governmental entities, all intended to ensure that such Districts are used solely in furtherance of the public purposes that were intended by the State legislature to be furthered when the legislation authorizing the formation of such Districts was enacted. All of these factors are evidence of the public control and public accountability that typically apply to Districts, as governmental entities, and that exist regardless of the number of property owners, electors or taxpayers that may exist in the District.

### Request for a Safe Harbor.

NABL is concerned that the reasoning of the TAM has led to confusion among issuers and their counsel as to the appropriate standard to be applied in determining whether a District qualifies as a political subdivision eligible to issue tax-advantaged bonds. As a result, transactions that would have otherwise gone forward have been put on hold pending clarification as to whether the holding of the TAM represents a change of what was thought to be well-established law, and bonds that were previously issued are trading at reduced prices as a result of the uncertainty, causing losses in value to current holders.

The Internal Revenue Service and Treasury have often issued guidance to establish “safe harbors” for issuers of tax-exempt obligations. Generally, if an issuer is within the confines of a safe harbor, it is able to market its obligations to investors, invest its bond proceeds or undertake an action related

to its bond-financed property with the comfort that the Internal Revenue Service will not challenge a particular issue of law. Given the concerns raised by the TAM, NABL believes that a safe harbor that, if satisfied, would result in a District being recognized as a political subdivision for purposes of the issuance of tax-advantaged obligations is appropriate. The requirements of the safe harbor are intended to reflect the requirements of existing authority, while also addressing the IRS's concerns over private entities potentially claiming political subdivisions status.

NABL respectfully suggests the following safe harbor:

An issuer will be a political subdivision for purposes of section 103 of the Code if:

1. The issuer is treated as a political subdivision, political body or municipal corporation under applicable State law,
2. The issuer has been delegated more than an insubstantial amount of the power of eminent domain, the power to tax or the police power; and
3. Upon the dissolution of the issuer, the assets of the issuer are distributed to, or at the direction of, a State or an entity that is treated as a political subdivision, political body or municipal corporation under applicable State law.

For purposes of the foregoing, an entity is generally treated as a political subdivision, political body or municipal corporation under applicable State law if, e.g., it is subject to legal requirements such as open meeting and public records laws, it is required to adopt a budget and conduct an audit, it is required to obtain State or local government approval of a business or service plan, it is subject to judicial validation procedures, its governing body members are subject to public conflict of interest and disclosure laws, or its governing body members or employees are treated as governmental officials or employees.

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Exhibit A

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#### FOOTNOTES

1 See *Comm'r v. Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945), dealing with bonds issued by the Port Authority of New York; *Texas Learning Technology Group v. Comm'r*, 96 T.C. 686 (1991); Rev. Proc. 84-37, 1984-1 C.B. 513; Rev. Rul. 77-164, 1977-1 C.B. 20. See also Ellen P. Aprill, "Municipal Bonds and Accountability to the General Electorate" Tax Notes (November 4, 2013), pp. 547-553.

2 1983-2 C.B. 184.

3 Although not specifically relied upon in the ruling, a distinction between Revenue Ruling 83-131 and a prior ruling (Revenue Ruling 57-193, 1957-1 C.B. 364) which had held that North Carolina electric and telephone membership corporations qualified as political subdivisions, was the fact that the applicable State statute had been amended such that assets of the corporation would no longer be distributed to the State upon dissolution.