

# **Bond Case Briefs**

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## **Tax-Exempt Bonds: Is It Possible for a Municipal Corporation Not to be a Political Subdivision?**

With the recent issuance of the [proposed regulations](#) that would redefine the term “political subdivision” for purposes of determining which entities can issue tax-exempt bonds under Section 103 of the Internal Revenue Code, as amended (the “Code”), the answer to this seemingly rhetorical question is “yes,” at least according to the Treasury Department. This is a significant, and startling, departure from the current Treasury regulations that define “political subdivision” for purposes of Code Section 103.

Current Treasury regulation § 1.103-1(a) provides that interest on an obligation issued by a political subdivision of a State is, except as otherwise provided, excluded from gross income of the holder of the obligation under Section 103(a) of the Code. Current Treasury regulation § 1.103-1(b) further provides that “the term ‘political subdivision’ . . . denotes any division of any State or local governmental unit which is a municipal corporation . . . .” A municipal corporation is therefore by definition treated as a political subdivision for purposes of Code Section 103. Although the term “municipal corporation” is not defined for this purpose, it has been interpreted, as illustrated by Revenue Ruling 80-136, 1980-1 C.B. 25, with deference to the laws of the applicable State to mean a city, village, town, or borough that is treated under the constitution or laws of the applicable State as a municipal corporation and imbued under such constitution or laws with the powers of self-government.

Like existing Treasury regulation § 1.103-1(a), proposed regulation § 1.103-1(a) provides that, subject to certain limitations, interest on an obligation issued by a political subdivision of a State is, pursuant to Code Section 103(a), excluded from gross income of the holder of the obligation. Proposed regulation § 1.103-1(c), however, goes on to state that:

The term political subdivision means an entity that meets each of the requirements of paragraphs (c)(2) (sovereign powers), (c)(3) (governmental purpose), and (c)(4) (governmental control) of this section, taking into account all of the facts and circumstances, or that is described in published guidance issued pursuant to paragraph (c)(5) of this section. Entities that may qualify as political subdivisions include, among others, general purpose governmental entities, such as cities and counties (whether or not incorporated as municipal corporations) . . . . (Emphasis added.)

The proposed regulations are to be commended for providing that incorporation as a municipal corporation is not a prerequisite for qualifying as a general purpose governmental entity. Counties and townships of counties are unincorporated but, like municipal corporations, clearly have the characteristics of general purpose governmental entities. The proposed regulations should, however, be revised to define a “general purpose governmental entity” as “a county, township of a county, city, town, village, or borough that is created under the constitution or laws of a State, regardless of whether incorporated as a municipal corporation.” Moreover, the proposed regulations should be revised to make clear that a general purpose governmental entity, as so defined, is a political subdivision without application of the sovereign powers, governmental purpose, and governmental

control tests set forth in proposed regulations § 1.103-1(c).

The foregoing refinements of the proposed regulations would accord with existing Treasury regulation § 1.103-1(b), which automatically treats a municipal corporation as a political subdivision for purposes of Code Section 103, and with sound policy. Under the constitution or laws of each State, a general purpose governmental entity, as defined above, is no mere special district, but instead: (1) has a substantial amount of taxing, eminent domain, and/or police powers; (2) exists to govern the area that comprises its physical jurisdiction; and (3) is accountable to its electorate and is not susceptible to private control. Subjecting these entities to the sovereign powers, governmental purpose, and governmental control tests of the proposed regulations introduces unwarranted confusion regarding their status as political subdivisions under Code Section 103 without advancing any discernable policy objective. Further, the application of the sovereign powers, governmental purpose, and governmental control tests to general purpose governmental entities is unnecessary to prevent privately controlled special districts from issuing tax-exempt bonds.

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