Re: Proposed amendments to 26 CFR part 1 under section 103 of the Internal Revenue Code regarding political subdivisions

The IRS has proposed new Treasury Regulations to redefine the qualifications to be a "political subdivision" for tax-exempt bond purposes. To be a political subdivision, an entity must meet each of three requirements of (i) having one or more sovereign powers, (ii) being constituted and operated for a governmental purpose, and (iii) being subject to governmental control. The proposed regulations call into question the status of special districts, authorities, commissions and other entities that have been created by state and local governments. If adopted in its current form, the proposed regulations will have an adverse impact on the ability of many governmental issuers to issue tax-exempt obligations. We are in accord with the continued application of the sovereign powers requirement, but we have serious concerns with the governmental purpose test and have a number of questions about the governmental control test.

Governmental Purpose

The section of the proposed regulation that attempts to define whether a local entity is a political subdivision based on whether it serves a "governmental purpose" is problematic. The determination of whether an entity serves a governmental purpose is based primarily on whether the entity carries out the public purposes that are set forth in the entity's enabling legislation and whether the entity operates in a manner that provides a significant public benefit with no more than incidental private benefit.

We agree that the federal government has a legitimate interest in restricting the amount of private benefit that is permitted to be provided by the issuance of tax-exempt bond bonds. But adding the broad vague incidental private benefit test could supersede the very detailed, asset-specific private business use tests developed under the Section 141 regulations. We note that the IRS ultimately narrowed and limited a generalized private economic benefit test in the proposed Section 141 regulations.

Moreover, our experience is that the definition of appropriate public purposes of a local government body has always been the exclusive domain of states and their legislatures, as codified in each state's constitution or statute, and courts in interpreting and applying the constitution or statute. Determining whether more than "incidental private benefit" exists has always been difficult and largely a political question. But under the proposed governmental purpose test, the IRS would be second-guessing State and local officials not only at the creation of the entity, but on an ongoing basis. Among the reasons the generalized private economic benefit test in the proposed Section 141 regulations attracted so much negative commentary is that such a standard is vague, ambiguous and difficult to apply.

To alleviate our concerns, the following options are recommended:

(1) Eliminate the governmental purpose test. As proposed, it creates a whole new private business use regime that is already adequately covered by Section 141 and represents a serious incursion by the federal government into the operations and decisions of State and local governments. The permitted amount of private benefit provided by tax-exempt bonds would more appropriately and more effectively focus on the use of the proceeds and not the governmental purpose of the issuer; or,

(2) Limit the application of the governmental purpose test to the creation of the entity. Limit the inquiry to the enabling legislation and/or articles of incorporation; or,

(3) Eliminate the governmental purpose test for general purpose political subdivisions such as cities, counties, towns, and special districts (that is, entities with substantial amounts of all three sovereign powers). Allowing the IRS to second-guess the actions and decisions of cities, counties towns, and special districts, and penalize them on the basis of more than incidental private benefit is completely unprecedented.

Governmental Control

The Proposed Regulations provide that a political subdivision must be governmentally controlled. We are sympathetic to the governmental control test, but we recommend that certain aspects of the test be reconsidered and clarified, with the inclusion of examples. As proposed, "governmental control" means an ongoing ability to exercise one or more of the following significant rights or powers on or over an entity on a discretionary and non-ministerial basis: (i) the right or power both to approve and to remove a majority of the governing body of the entity; (ii) the right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency; or (iii) the right or power to approve or direct the significant uses of funds or assets of the entity in advance of that use.

Many existing special districts, authorities, commissions and other entities across the nation do not meet this definition of governmental control. Particularly problematic is the right or power to approve and to remove a majority of the governing body. This may include public universities and colleges, port districts and authorities, housing authorities, regional transit authorities, public transportation benefit areas and joint municipal utility services authorities. Members of the governing bodies of these organizations are typically appointed by elected officials, either at the state or the local level, such as the county legislature or by participating governments. In many cases, state law does not prescribe a specific method for removal from office for these political subdivisions, particularly ones that are discretionary in nature. Many commentators have interpreted the right to remove a majority of an entity's governing body to be satisfied by the right to remove any member "for cause." The problem with having only a right to removal for cause arises because the proposed regulations also provide that procedures designed to ensure the integrity of the entity but not to direct significant actions of the entity are insufficient to constitute control of an entity. Examples of such procedures include

requirements for submission of audited financial statements of the entity to a higher level State or local governmental unit, open meeting requirements, and conflicts of interest limitations.

We are requesting refinement and clarification of the governmental control test, not its elimination. However, we have the following questions:

(1) Do “for cause” removal provisions constitute only procedures “designed to ensure the integrity of the entity?” The proposed regulations should clarify whether this sort of “for cause” removal is intended only to ensure the integrity of an entity rather than control.

(2) Is the power of the board of a political subdivision (such as a city) periodically to reappoint members of another entity (such as members of a limited purpose service authority) for fixed terms tantamount to the right or power to elect a majority of the governing body in periodic elections of reasonable frequency? If so, then the "for cause" removal procedures should not be a problem.

(3) How does the governmental control test apply to a multi-jurisdictional entity, such as a regional jail authority or a multijurisdictional water and sewer authority? Typically, each member locality has the power to appoint one or more members for fixed terms (with the general “for cause” removal power), but no one locality can appoint or remove a majority of the entity’s board.