

## Summary of Proposed Regulations on Political Subdivisions

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On February 23, the IRS published proposed regulations regarding the definition of “political subdivision” ([81 Fed. Reg. 8870](#)). The proposed regulations define a political subdivision as an entity that meets three requirements: (1) sovereign powers, (2) governmental purpose, and (3) governmental control.

The “sovereign powers” prong of the test requires that the entity has the right to exercise a substantial amount of at least one of the three long-recognized sovereign powers — taxation, eminent domain, and police power.

The “governmental purpose” prong of the test requires that the entity serve a governmental purpose, based generally on whether the entity carries out the purpose set forth in its enabling legislation and “whether the entity operates in a manner that provides a significant public benefit with no more than incidental private benefit”.

The “governmental control” prong of the test requires that a State or local government exercise control over the entity. Control must be vested with a State or local government and/or with an electorate that is not a “private faction.”

- “Control” means the right or power to direct significant actions of the entity. The proposed regulations provide examples, such as the power to approve or remove a majority of the governing board of the entity; the right to elect a majority of the board in elections held with reasonable frequency; and the power to approve or direct significant uses of assets of the entity. Mere procedural safeguards (like providing audited financial statements to a government or open meeting requirements) are not sufficient.
- A “private faction” is an electorate of which an “unreasonably small” number of private persons are able to exercise control. While the presence of such a private faction is generally a facts and circumstances determination, a private faction will exist if three private persons control the majority of the vote, and a private faction will not exist if the aggregate vote of 11 or more unrelated persons is required to exercise control (e.g., an electorate with 20 unrelated private persons, each having an equal vote, would require 11 private persons to exercise control).

The proposed regulations generally become effective 90 days after they are published as final regulations. However, there are certain transition rules that delay this effective date. For purposes of determining whether an entity is a political subdivision, the proposed regulations do not apply to bonds issued prior to the general effective date or to refunding bonds issued after the general effective date if the weighted average maturity is not extended, but would apply for other purposes (such as whether a new entity that subsequently became a user of bond-financed project qualified as a State or local government). Entities in existence prior to March 24, 2016 are exempted from application of the proposed regulations for all purposes under Code sections 103, and 141 – 150 for an additional three years after the general effective date. If an issuer or entity so desires, it may elect application of the new definitions in circumstances where the new definitions would not otherwise apply.

These proposed regulations were issued after [TAM 201334038](#), which we [previously discussed](#). Treas. Reg. § 1.103-1(b) currently provides that: “[t]he 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. 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.”

We will be providing further commentary on these proposed regulations in coming weeks.

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