

**Internal Revenue Service**

Department of the Treasury

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CC:TEGE:EOEG:TEB/PLR-123347-01  
Date:  
October 26, 2001

**LEGEND:**

Agency =  
State =  
Date 1 =  
Town A =  
Town B =  
Town C =  
Electric Association A =  
Electric Association B =  
Project =  
Association =

Dear

This letter is in response to your request for a ruling that the Agency qualifies as a political subdivision of the State for purposes of § 103 of the Internal Revenue Code and that, accordingly, the Agency is not required to file federal income tax returns or pay federal income tax on its income.

**Facts and Representations**

You make the following factual representations. The Agency was created pursuant to special legislation enacted by the State legislature and came into legal existence on Date 1. The Agency is an entity with an existence separate from the Member Utilities. The Member Utilities consist of the municipal utilities of Town A, Town B, and Town C (the "Municipal Utilities"), as well as Electric Association A and Electric Association B (the "Electric Associations"). The Municipal Utilities are each home rule municipalities and political subdivisions of the State. The Electric Associations are cooperative electric companies that have each received determinations from the Service that they are tax-exempt under § 501(c)(12) as mutual or cooperative companies.

The Agency was created to own and operate the Project, which consists of four hydroelectric generating facilities. The hydroelectric facilities that make up the Project were originally constructed to replace existing diesel generation with renewable

hydroelectric generation at a cost effective rate.

The Agency is authorized to exercise the power of eminent domain, subject only to the limitations that (1) the Agency may exercise the power only to carry out its authorized purposes, and (2) it may exercise the power only within the boundaries of the Project. In exercising its eminent domain power, the Agency will use the same declaration of taking procedure available to cities and the State, rather than the procedures available to privately owned public utilities.

The Project is currently owned and managed by the Association, a political subdivision of the State, and delivers power to the Member Utilities. The Agency will purchase the Project from the Association.

Each Member Utility will appoint one director and one alternate director to the Agency's board of directors. Each director and alternate director will serve for a term of one year, or until her successor is appointed.

Directors and alternate directors may only be removed for cause. In order to remove any director or alternate director for cause, the directors appointed by the Municipal Utilities must unanimously resolve that there is cause for removal and that the director or alternate director shall be removed. No director or alternate director will be entitled to vote on the removal of a director or alternate director if that director or alternate director is the subject of a vote for removal, or if that director or alternate director was appointed by the same Municipal Utility that appointed the director or alternate director whose removal is in question. Directors and alternate directors appointed by the Electric Associations will, under no circumstances, be entitled to vote on the removal of a director or alternate director.

Each director has one vote on Agency affairs. The board acts by simple majority, except with respect to decisions that would fundamentally change its organization or operations, which must be made unanimously. For instance, upon the unanimous consent of the Agency's directors, part of the Project may be sold to a Member Utility. The Member Utility would take title subject to the limitation described in (3) below.

The Agency was created pursuant to special legislation enacted by the State legislature. To insure that the Agency fulfills its public purposes, the legislature has retained control over certain fundamental decisions by the Agency's board. Certain actions of the Agency's board thus require both a unanimous vote of the Agency's board and the legislative approval of the State. These include: (1) admitting a new Member Utility to the Agency; (2) selling part of the Project to anyone other than a Member Utility; and (3) the sale, by a Member Utility, of part of the Project to any purchaser who is not then a Member Utility.

Distributions of net revenues of the Agency to the Member Utilities are prohibited during the life of the Agency. Upon dissolution of the Agency, assets of the Agency

must be distributed only to governmental entities. The assets of projects serving Member Utilities that are governmental entities (the Municipal Utilities) will, upon dissolution of the Agency, be distributed to those governmental entities. The assets of projects serving Member Utilities that are not governmental units (the Electric Associations) will, upon dissolution of the Agency, be distributed to the municipality or municipalities that are served by those Member Utilities.

### **Law and Analysis**

The Internal Revenue Code does not define the term “political subdivision.” Section 1.103-1(b) of the Income Tax Regulations provides that the term “political subdivision” denotes any division of any state or local governmental unit that is a municipal corporation or that 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 these units. Revenue Ruling 78-276, 1978-2 C.B. 256, states that the term “political subdivision” has been defined consistently for all federal tax purposes as denoting either (1) a division of a state or local government that is a municipal corporation, or (2) a division of such state or local government that has been delegated the right to exercise sovereign power.

Accordingly, our first inquiry is whether the Agency is a division of the State. In determining whether an entity is a division of a state or local governmental unit, important considerations are the extent the entity is (1) controlled by the state or local government unit, and (2) motivated by a wholly public purpose. Revenue Ruling 83-131, 1983-2 C.B. 184.

Consideration of these principles as they apply to the facts in this case, leads us to conclude that the Agency is a division of the State. The Agency was created pursuant to State legislation, and the legislature may intervene to prevent a fundamental departure of the Agency from its public purposes. That is, before the Agency can take certain actions, State legislative approval is necessary in addition to approval by the Agency’s board. The State can thus prevent changes in the organization or operation of the Agency that would threaten the public purposes for which the Agency was created. Also, all of the Agency’s directors and alternate directors are subject to control by the Municipal Utilities. A majority of the directors are appointees of the Municipal Utilities, and only the directors appointed by the Municipal Utilities may remove a director for cause. Directors and alternate directors appointed by the Electric Associations are not entitled to vote on the removal of a director or alternate director.

The Agency’s purpose of owning hydroelectric generating facilities that provide electricity at a cost effective rate to the citizens of the State served by the Member Utilities, is a wholly public purpose.

Having concluded that the Agency is a division of the State, our next inquiry is whether the Agency has been delegated the right to exercise sovereign power.

Three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the police power. Estate of Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B.6, aff'd, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). It is not necessary that all three of these powers be delegated in order to treat an entity as a political subdivision for purposes of the Code. However, possession of only an insubstantial amount of any or all of the sovereign powers is not sufficient. All of the facts and circumstances must be taken into consideration, including the public purposes of the entity and its control by a government. Revenue Ruling 77-164, 1977-1 C.B. 20.

Under State law the Agency is granted powers of eminent domain to carry out authorized purposes, subject only to the limitations that (1) the Agency may exercise the power only to carry out its authorized purposes, and (2) it may exercise the power only within the boundaries of the Project. These powers of eminent domain are commensurate with a substantial exercise of that power.

### **Conclusion**

The Agency has been delegated the right to exercise sovereign power and is also a division of the State since it is controlled by the State and is motivated by a wholly public purpose. We thus conclude that the Agency is a political subdivision of the State under § 1.103-1(b).

Except as specifically stated above, no opinion is expressed regarding the consequences of this transaction under any provision of the Code or regulations thereunder.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,  
Assistant Chief Counsel  
(Exempt Organizations/Employment Tax/  
Government Entities)  
By: Timothy L. Jones  
Assistant to the Chief  
Tax Exempt Bond Branch