

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 01, 2006

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-118916-06

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Academy =

Lease
Agreement =

State =

State Law A =

State Law B =

State Law C =

State Law D =

State Constitution =

University Board
or Authorizing
Body =

University =

Charter =

Date 1 =

Lender =

State Funds =

ISSUES:

1. Whether the Academy is a political subdivision within the meaning of Treas. Reg. §1.103-1(b).
2. Alternatively, if the Academy is not a political subdivision, whether its debt is issued on behalf of a State or local governmental unit within the meaning of Treas. Reg. §1.103-1(b).

CONCLUSIONS:

1. The Academy is not a political subdivision within the meaning of Treas. Reg. §1.103-1(b) because it has not been delegated a substantial amount of the sovereign powers of the State.
2. Even though the Academy is not a political subdivision of the State, the debt of the Academy is issued on behalf of the State within the meaning of Treas. Reg. §1.103-1(b).

FACTS:

On Date 1, the Academy entered into a Lease-Purchase Agreement (the "Lease Agreement") with the Lender. The Lease Agreement is a capital lease. The proceeds of the Lease Agreement were used by the Academy to acquire educational facilities (the "financed property"). Pursuant to the Lease Agreement, payments of principal and interest thereon are made from State Funds received by the Academy. The repayment of the Lease Agreement was further secured by a mortgage on the financed property. At the time the Lease Agreement was entered into, counsel to the Lender provided a legal opinion that payments of interest on the Lease Agreement were tax-exempt because the Academy is a "political subdivision" within the meaning of §103(c) of the Internal Revenue Code of 1986 (the "Code"). The Academy designated the Lease Agreement as a "qualified tax-exempt obligation" pursuant to §265(b)(3)(B) of the Code.

The Academy is incorporated as a nonprofit corporation pursuant to the provisions of State Law A and was organized for the purposes of operating as a public school academy in the State pursuant to State Law B. The Academy is prohibited under its articles of incorporation (the "Articles") from carrying on any activity which is not an integral part of the function of providing public education to students residing in the State. The Articles provide that no part of the net earnings of the Academy shall inure to the benefit of or be distributable to its directors, board, officers, or other private persons, or organization organized and operated for profit. Upon dissolution of the Academy, the Academy is required to dispose of its assets to the authorizing body (defined below) or to the State or any political subdivision of the State.

State Law B provides for numerous functions, permitted activities, manner of creation and method of supervision of public school academies such as the Academy. Academies formed under State Law B are considered public schools under the State Constitution, including for purposes of receiving State Funds. Under State Law B, a public school academy is a body corporate and a governmental agency, and the powers granted to it constitute the performance of essential public purposes and governmental functions of the State.

Under State Law B, a public school academy is permitted to borrow money and issue tax-exempt bonds. Bonds issued by a public school academy are the full faith and credit obligations of the academy, pledging the general funds of the academy or any other money available to repay debt. Any debt of a public school academy does not constitute an obligation of the State or the authorizing body. Public school academies are not permitted to levy ad valorem property taxes and are not delegated police powers. An academy may condemn property (after just compensation has been determined and paid) in accordance with State Law C, but only with the express written consent of its authorizing body. There is no evidence in this case that this approval would be automatically given by the University Board.

State Law B provides that a public school academy must be authorized to operate by entering into a contract with an “authorizing body.” State Law B permits the governing board of a State public university to act as an authorizing body. The Academy entered into such a contract (the “Charter”) with the University Board, a governing body of a State public university (the “University”), pursuant to which the University Board approved the establishment of the Academy as a public school academy. The University is a State public university created pursuant to the State Constitution and the laws of the State. The University Board is an eight-member, State controlled body corporate whose members are appointed by the Governor of the State, by and with the consent of the State senate. The parties agree that the University Board is a part of the State. The University Board is charged with the general supervision of the University and the control and direction of all expenditures from the funds of the University. The University Board approved the Academy’s Articles and its bylaws. The Academy is prohibited from making any amendments to the Articles or its bylaws without the approval of the University Board.

Members of the board of directors of the Academy (the “Academy Board”) are appointed, and can be removed, by the University Board. The initial members of the Academy Board were authorized by the University Board. Subsequent replacements are appointed by the University Board from a list of recommendations submitted by the Academy. All members of the Academy Board are considered public officials under the State Constitution and are required to take the oath of public office. The Academy and its incorporators, board members, officers, employees and volunteers have governmental immunity under the laws of the State.

Under State Law B, the University Board is required to oversee the Academy’s compliance with the terms of the Charter and with applicable law on an ongoing basis. The University Board can revoke the Charter if the Academy fails to: (1) meet the educational goals contained in the Charter, (2) comply with applicable law, (3) meet generally accepted public sector accounting principles, or (4) if the University Board finds the existence of one or more grounds for revocation as specified in the Charter. The decision to revoke the Charter is solely within the discretion of the University Board, is final, and is not subject to review by any court or State agency.

The operations of the Academy are also supervised by the State Board of Education. The Board of Education has leadership and general supervision over all public education, including public school academies, but excluding institutions of higher education granting baccalaureate degrees. The Board of Education serves as the general planning and coordinating body for all public education and advises the State legislature as to financial requirements in connection therewith. The members of the Board of Education are elected; additionally, the governor of the State has a non-voting, ex-officio appointment as a member of the Board of Education. The Board of Education also has the ability under State Law B to suspend the power of an authorizing body to

issue new contracts for public school academies if it determines that an authorizing body is not engaging in appropriate continuing oversight of a public school academy.

The Academy is to be financed primarily from State Funds received pursuant to State Law D. State Funds are generated by the taxing power of the State and distributed to each public school in the State on a per pupil basis. Public school for this purpose includes public school academies such as the Academy. The University Board is the Academy's fiscal agent for purposes of receiving and transmitting the Academy's allocation of the State Funds. Accordingly, all payments of State Funds allocable to the Academy are transmitted to the University Board, which then transmits the funds to the Academy.

LAW AND ANALYSIS

Section 103(a) provides that gross income does not include interest on any State or local bond. Section 103(c) provides that the term "State or local bond" means an obligation of a State or political subdivision thereof. Treas. Reg. §1.103-1(b) provides that obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit.

The Internal Revenue Code does not define the term "political subdivision." However, Treas. Reg. §1.103-1(b) provides that the term "political subdivision" 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. Rev. Rul. 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.

Our first inquiry is whether the Academy is a division of a state or local government unit. 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. Rev. Rul. 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 Academy is a division of the State. In accordance with the State Constitution, education is a public purpose of the State. Public schools perform the

education function for the State. The Academy was created pursuant to State Law B which expressly permits and fosters the creation and operation of public school academies. Under State Law B, public school academies such as the Academy are public schools, and the powers granted by State Law B to academies constitute the performance of essential public purposes and governmental functions. Private inurement is not allowed in the organization or operation of the Academy. In addition, the operations of the Academy are subject to the control and supervision of the University Board, which is a part of the State, as well as by the State Board of Education. The State is the principal source of operating expenses for the Academy through the provision of State Funds. Accordingly, we conclude that the Academy is a division of the State.

Having concluded that the Academy is a division of the State, our next inquiry is whether the Academy is a municipal corporation or has been delegated the right to exercise sovereign power, and therefore can be considered a political subdivision of the State. The Academy is not a municipal corporation so we therefore turn to the question of whether the Academy 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. See 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. Rev. Rul. 77-164, 1977-1 C.B. 20; Rev. Rul. 77-165, 1977-1 C.B. 21.

The Academy does not have the power to tax or police power. Under State Law B, the Academy is granted the power to condemn property in accordance with certain sections of State Law C. However, the Academy can only exercise this power if it first obtains the written authorization of the University Board, and there is no evidence that this approval would be automatically given. We believe that the approval required in this case represents a significant limitation on the ability of the Academy to exercise the power to condemn. Based on the facts and circumstances of this case, we do not believe that this limited power to condemn constitutes a substantial delegation of sovereign power. Accordingly, the Academy is not a political subdivision of the State.

Having concluded that the Academy is not a political subdivision of the State, we next examine the question of whether the debt of the Academy is issued on behalf of a State or local governmental unit within the meaning of Treas. Reg. §1.103-1(b). Rev. Rul. 57-187, 1957-1 C.B. 65, holds that bonds issued by an industrial development board are considered issued on behalf of a political subdivision of the state because the following conditions are met: (1) the entity is formed only after the governing body of the state or political subdivision has formally approved the entity's creation, (2) the

board of directors of the entity is elected by the governing body of the state or political subdivision, (3) the entity is empowered to issue bonds in furtherance of the purposes for which it is established, (4) the entity is a nonprofit organization and none of its net earnings inure to the benefit of any private person, and (5) upon dissolution of the entity, title to all property it owns vests in and becomes the property of the state or political subdivision which creates it. Although this revenue ruling dealt with an industrial development board, the analysis contained therein has been applied to a variety of governmental entities.

Applying the criteria of Rev. Rul. 57-187 to the facts as presented, we conclude that the Academy qualifies as an “on behalf of” issuer of the State for purposes of Treas. Reg. §1.103-1(b). The Academy was formed upon entering into the Charter with the University Board in accordance with State Law B. The University Board which is a part of the State approves and appoints the members of the Academy Board. The Academy is authorized under State Law B to issue bonds to carry out its purposes. The Academy is a nonprofit corporation and none of its net earnings inure to the benefit of any private person. Upon dissolution of the Academy, title to all property will vest in and become the property of the University Board or the State or any of its political subdivisions. Accordingly, we conclude that the debt of the Academy is issued on behalf of the State within the meaning of Treas. Reg. §1.103-1(b).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.