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Treasury Corrects Proposed Regulations on What is a Political Subdivision: Squire Patton Boggs

Recently, Treasury proposed a new test for an entity to qualify as a "political subdivision" that is entitled to issue tax-exempt bonds on its own behalf. (These are merely proposed regulations, and are not yet governing law.)

The proposed regulations included some transition rules that Treasury put in place to make sure that the proposed regulations would only apply prospectively. (Prop. Reg. 1.103-1(d)(2) – (4).)

One of the transition rules said that solely for purposes of determining whether outstanding bonds of an entity were issued by a political subdivision, the new, more restrictive definition of political subdivision would not apply to that entity with respect to its outstanding bonds that are issued no more than 30 days after Treasury finalized the proposed regulations. We immediately noted a nasty trap lurking in these new rules. If Treasury finalized the rules in their current form, this transition rule would mean that existing bonds would be treated as issued by a political subdivision (under the current definition of political subdivision), but the issuer itself would be treated as a private user (because the transition rule only applies for purposes of determining whether the bonds were issued by a political subdivision, and no further). The same trap would ensnare refunding bonds that were intended to qualify from the additional transition rule that would grandfather in refunding bonds that did not extend the weighted average maturity of prior bonds issued under the old definition of political subdivision.

Our immediate thought was that this trap could not have been what Treasury intended, and Treasury has agreed. Treasury corrected the proposed regulations yesterday. The corrections make it clear that the transition rules apply for all tax-exempt bond purposes, avoiding this potential trap. The revised provisions look like this:

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The proposed regulations have many other substantive flaws that the tax-exempt bond community will continue to discuss, which are based on policy disagreements between Treasury and the tax-exempt bond community. Treasury should be commended for fixing this obviously unintended result in the meantime.

Squire Patton Boggs – John W. Hutchinson

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