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Bond Lawyers Blast Proposed Political Subdivision Rules.

WASHINGTON – Bond lawyers on Thursday criticized the political subdivision rules recently proposed by the Treasury Department and Internal Revenue Service, claiming they would trample states' rights, alter the landscape for public financing, and jeopardize the tax-exempt status of millions of dollars of municipal bonds.

The lawyers pummeled Treasury and IRS officials with questions and concerns about the rules at the National Association of Bond Lawyers' 14th Tax and Securities Law Institute here.

The federal officials thought they might have minimized controversy by releasing a prospective effective date for the rules the night before the meeting. The initial rules faced a firestorm of criticism for proposing a technically complicated effective date that would have been prospective under certain tax-exempt bond provisions of the tax code, but not others.

But NABL members were still upset by the substance of the proposed rules. Richard Chirls, a lawyer with Orrick, Herrington & Sutcliffe who sat in the audience during a panel discussion, accused Treasury and the IRS of "stepping on the toes of state and local governments" and said, "I think it's quite offensive."

Chirls noted that states, for many years, have set up political subdivisions within their jurisdictions under state laws that specify that an entity is a political subdivision if it has been delegated a substantial amount of at least one of three sovereign powers: eminent domain, taxation and policing.

These proposed rules, however, would add two new requirements — that political subdivisions serve a governmental purpose and be governmentally controlled.

Under the proposed rules, the determination of whether an entity serves a governmental purpose would be based, in part, on whether the entity carries out the public purposes set forth in its enabling legislation and whether it operates in a manner that provides a significant public benefit "with no more than an incidental private benefit."

To be governmentally controlled, a political subdivision would have to be controlled by a state or local governmental unit or an electorate. The proposed rules set forth what Chirls later called "arbitrary new standards for voting" to ensure the political subdivision is not controlled by private parties.

Mike Larsen, a lawyer from Parker Poe Adams & Bernstein, said he did not see any demonstrated need for new rules and asked a Treasury official on the panel why they were proposed.

John Cross, Treasury's associate tax legislative counsel, told NABL members that IRS audits had exposed a vulnerability of political subdivisions to be controlled by private entities and that this had "raised concerns at the highest levels of government."

"We tried to be targeted with the way we addressed that" with the proposed rules Cross said, adding, "We don't think there's a big problem here."

But Chirls insisted that the proposed rules' attempt to expand on what states are allowed and not allowed to do "is offensive."

Cross reminded the lawyers that that the tax exemption of munis "is a federal subsidy" and said the federal government plays a role in determining how that subsidy is used.

Many of the lawyers in the room were concerned that the rules would jeopardize political subdivisions that were initially temporarily controlled by developers who sold bonds to build infrastructure for retirement communities or water or irrigation districts before residents moved in or farmers could get water and play a part in governing the districts.

Cross said federal officials are aware that many political subdivisions are initially controlled by developers and that there's plenty of opportunity to provide public comments to the Treasury and IRS on how they should deal with this issue.

Richard Moore, a lawyer with Orrick who was on the panel, worried that the proposed requirement for a political subdivision to operate in a manner that provides a significant public benefit "with no more than an incidental private benefit" would set up another "private use test" and would allow IRS auditors to audit anything they don't like about a political subdivision. Many of the lawyers also complained the proposed requirement was too broad.

Spence Hanemann, an attorney in the IRS' Office of Chief Counsel, said bond lawyers must tell the IRS how it can limit the "no more than an incidental private benefit" requirement to make it more reasonable. The best way to make the requirement more reasonable would be to get rid of it, said Mitch Rapaport, a lawyer at Nixon Peabody.

Hobby Presley, a lawyer with Balch & Bingham, said the rule will have unintended consequences for many public universities that are set up under state constitutions and have procedures for electing trustees. Those procedures might not comply with the proposed rules' voting standards to demonstrate governmental control, he said.

Another lawyer in the audience said Pennsylvania has created a number of political subdivisions that have board members who are not elected on an ongoing basis and worried about how they would fare under the proposed rules.

Perry Israel, a lawyer in Sacramento who represents the Village Center Community Development District in Florida that is the subject of an IRS audit that led to the proposed rules, said he is grateful that rules were proposed that are subject to public comment and will be prospectively effective.

NABL members joked that Israel should win an award for sucking up to the Treasury and IRS and that his audit should be closed.

Treasury and IRS lawyers decided to write rules on political subdivisions after the IRS' Chief Counsel's Office issued a very controversial technical advice memorandum in 2013 concluding that the Village Center CDD was not a political subdivision, and therefore could not have issued millions of dollars of tax-exempt bonds as it did from 1993 to 2004, because its board was and will always be controlled by the developer rather than publicly elected officials. The audit had been ongoing for years and has still not been resolved, although the bonds have been redeemed.

Lawyers argued that the TAM's assertion that control by elected officials is necessary for an entity to be a political subdivision was a new requirement and that such changes should be made through regulatory proposals that can be commented upon rather than through a TAM in an enforcement

proceeding.

Meanwhile, the English comedian and television host of “Last Week Tonight,” John Oliver, recently aired a segment on “special districts” that compared them to “cults” and said they can take your money without your even being aware you are in them. He said they are being replicated all over the country with little or no standards or regulatory oversight.

The Bond Buyer

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March 10, 2016

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