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Slowing of Muni Tax Regs Seen in 2017, But Three Projects Watched.

WASHINGTON – Municipal market participants see a slowing of Treasury Department and Internal Revenue Service guidance and rules in 2017, but plan to closely watch rules on political subdivisions, tweaks to management contract guidance, and rules for public approval of private activity bonds.

"The change in the White House to a Trump administration will certainly put a severe damper on any regulatory activities for most of [2017]," said Matthias Edrich, a tax partner with Kutak Rock in Denver. "Not just for public finance but for any regulatory efforts."

Emily Brock, director of the Government Finance Officers Association's (GFOA) federal liaison center, agreed. "I think what we will see is a bit of a calming down of the priority list," Brock said. "One thing that drew our attention … is the political subdivision definition. We'll continue to keep an eye on that."

John Cross, Treasury's associate tax legislative counsel, said that while he can't comment on regulatory priorities that will be set by the incoming policymakers for the new administration, Treasury's two most active existing muni projects at the staff level are The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) public rules for private activity bonds (PABs) and bond reissuance regulations.

He also said the staff has been considering some discrete, clarifying changes to the recent more flexible management contract safe harbors under Rev. Proc. 2016-44, which was issued last year.

In October, the Treasury and IRS released their final 2016-2017 priority guidance plan, which included seven projects for tax-exempt bonds. Three projects were completed in 2016 – final issue price rules, guidance on management contracts, and final rules on arbitrage investment restrictions. The remaining ones are bond reissuance rules, guidance on remedial actions for tax-advantaged bonds, final regulations for public approval of PABs, and a new definition of political subdivisions for this year.

TEFRA Regulations

Perhaps no other pending regulatory measure is as long-awaited as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which originally date back nearly 35 years.

Bond attorneys and other market participants have long clamored for a clarification of public approval requirements for private PABs, which were written in temporary form in 1983 by Treasury and the IRS.

In 2008, proposed regulations, which were well received by market participants, were released, but have yet to be finalized.

Officials from the National Association of Bond Lawyers (NABL) have previously told The Bond Buyer they believe, and hope, the TEFRA rules will finally be completed in 2017.

NABL has called for a clarification of the TEFRA public approval requirements for PABs, which it said were burdensome. The group has recommended regulators broaden the allowance for PAB proceeds to be used for working capital without the public notice specifically mentioning that purpose.

In order to be tax exempt, PABs must be approved by the issuer and, in some cases, the governmental entity that has jurisdiction over the area where the bond-financed facility will be located. The bonds can be approved by voter referendum or by elected officials following a public hearing.

Ed Oswald, a partner with Orrick, Herrington, and Sutcliffe in Washington, said he will be tracking TEFRA developments closely, which he said are long overdue.

“The original regulations came out in 1983 and are very antiquated,” Oswald said. “I think the muni market would love to have the TEFRA regulations in final form.”

Stefano Taverna, an attorney with McCall, Parkhurst & Horton in Dallas, and the chair of the American Bar Association’s tax-exempt financing committee, was cautiously optimistic about final regs in 2017.

“TEFRA regs have been active for quite some time so hopefully they get that out and publish something later this year,” Taverna said.

Edrich said that the release of final issue price rules last month may indicate the agency is trying to “clear the deck” of its highest priority guidance projects, but warned that the TEFRA regulations could be stalled during the first year of the Trump presidency.

Taverna said he expects market participants to spend the coming months trying to determine the issue price regulations’ impact on certain transactions, particularly competitive sales, since they do not become effective until June of this year.

The issue price regs contain special allowances for competitive sales and establish that the issue price for competitive sales will be the reasonably expected initial offering price under certain conditions.

The final rules are meant to be more flexible and workable, Cross said.

Political Subdivisions

Several muni market participants also said they will be watching developments on definition of a political subdivision for purposes of tax-exempt, tax credit and direct pay bond provisions — another project outlined in the guidance plan.

Most muni market participants felt the political subdivision rules proposed in February of last year by Treasury and the IRS were overly restrictive and could jeopardize the tax-exempt status of some outstanding bonds.

John Vahey, managing director of federal policy for Bond Dealers of America (BDA), said his group is hoping for more clarification for incidental private benefit rules that he feels raise more questions than answers. Vahey said BDA has questions tied to community development projects and how land

purchases, for example, impact incidental private benefit.

The proposed rules say, among other things, that political subdivisions must serve a governmental purpose "with no more than an incidental private benefit."

"We're hoping for more clarification for incidental private benefit," Vahey said. "There's a few points that we've raised and that's one of the biggest ones."

The tax regulators began writing rules on political subdivisons after the IRS issued a technical advice memorandum in 2013 that found the Village Center Community Development District in Florida was not a political subdivision and could not have issued tax-exempt bonds because its board was developer-controlled rather than by publicly elected officials.

Bond lawyers complained the IRS was trying to change standards through the enforcement process rather than through public rulemaking, which would allow for public input.

The Treasury and IRS proposed rules on the definition of a political subdivision last February.

Under the current definition, an entity is a political subdivision that can issue tax-exempt bonds if it has a right to exercise a substantial amount of at least one of three recognized sovereign powers of a state or local governmental unit: eminent domain, taxation or police. The proposed rules would add two new requirements: that a political subdivision serve a governmental purpose "with no more than an incidental private benefit" and that it be governmentally controlled.

The agencies received many comments on the proposed rules, most of them critical, saying they were unworkable and could upend the muni market. They asked the rules be reproposed, at a minimum, or simply withdrawn.

Edrich, meanwhile, said that any efforts to "fix uncertainties" in the market created by the proposed regulations relating to the definition of a political subdivision may be stalled during Trump's first year.

Management Contracts

Another regulatory issue for the bond community in 2017 is guidance pertaining to management contracts.

In August, the IRS released Rev. Proc. 2016-44, which extended terms of long-term management contracts to up to 30 years from the previous 15-year limit, and also removed the formulaic fixed fee requirements for manager compensation.

Bond lawyers initially lauded the new management contract safe harbors, which they found to be more liberal than restrictive safe harbors established under Rev. Proc. 97-13 released in 2013.

But questions and concerns soon arose regarding the guidance, which was meant to allow for more incentive compensation, bond-financed infrastructure projects, and public-private partnerships.

NABL said the guidance is confusing and could limit the usefulness of safe harbors in short-term contracts. Concerns were also raised about how the guidance should be implemented.

Questions also surfaced regarding whether the term of a contract is retested when one is modified or a new one is entered into.

Taverna while the guidance made strides in liberalizing management contract guidelines, he hopes comments submitted to Treasury in November will lead to clearer guidance in the coming year.

The guidance "liberalized a lot of guidelines but in that process, it left open some questions," Taverna said. "Particularly what it means to have sharing of land losses and sharing of net profits."

"The purpose of the comments is to ask Treasury for more narrow guidance in respect to the revenue procedure and to provide more certainty to the corners of that guidance," he added. "Other than that I think they've done a very good job with the guidance plan."

Oswald agreed. "We're hoping for some additional guidance or amplification regarding the guidance which is otherwise helpful," Oswald said. "This would fill the void that other practitioners have observed in terms of details."

The safe harbors under Rev. Proc. 2016-44 apply to any management contract entered into on or after Aug. 22, but issuers can also apply the safe harbors to management contracts entered into before that date.

The guidance created three provisions containing limits ensuring no private ownership or leases: a state or local government "must exercise a significant degree of control of the managed property," the state or local government must bear the risk loss for damage of managed property, and the private party must agree not to take any tax position that is inconsistent with being a service provider.

Both Oswald and Taverna said they will also be tracking bond reissuance regulations, another Treasury guidance plan item that has not moved forward.

"The reason they're important is that the rules had been put out over years, somewhat on an ad hoc basis, and a lot were issued during the 2008 downturn when the market needed relief," Oswald said. "The reissuance guidelines need to be reformatted and reorganized."

Taverna said a common concern he has heard in the industry is what type of effect the Trump administration could have on published regs.

"What I find interesting and what a lot of folks are wondering is if the new administration will have an effect on the types of regulations published," Taverna said. "[Donald] Trump said that for all new regulations that come out you'll have to take two out. I don't know if that will have an impact on the streamlining of regs."

TEB

All eyes for the time being will be on Imraan Khakoo, the acting director of the IRS' Office of Tax Exempt Bonds (TEB) who replaced Rebecca Harrigal late last year.

Khakoo had been Harrigal's acting assistant. IRS officials did not specify how long Khakoo will be acting director of TEB.

Mark Scott, a former director of TEB who now has a private practice focused on representing whistleblowers, said he believes Khakoo's lack of muni tax law knowledge, an area where agents are struggling to apply tax law and where enforcement is lacking, "doesn't help anything."

"Efficiency in TEB has gone down and it is getting worse at identifying good cases," Scott said. "Even when they are identified, [TEB] is struggling to get agents to complete cases. The cases are

there and the work can be done. Still, I anticipate this trend continuing."

The number of agents doing audit work is roughly 60-65 overall, which is lower than the 70-75 agents Scott said he had in his peak when he served as TEB head.

According to IRS spokesman Dean Patterson, TEB closed 570 audits in fiscal 2016 and entered into 18 closing agreements in the same period.

TEB entered into 61 settlements under the voluntary closing agreement program (VCAP), a substantial drop from the 105 VCAP settlements reached during the prior fiscal year.

The 570 closed audits were two more than TEB closed in fiscal 2015, while the 18 closing agreements were one less compared to the prior fiscal period.

The total dollar amount from audit settlements in fiscal 2016, which ended on Sept. 30, was $10.72 million, and $11.68 million for VCAP settlements.

Patterson also noted that TEB does not have any webcasts planned for 2017.

Scott speculated that a reason VCAP figures have been dropping is due to a decrease in refundings, which had spiked several years ago. This trend may continue, he said, due to over-auditing in some areas, and allocating resources inefficiently.

"When you have a strong enforcement program, the voluntary closing agreement program motivates issuers to identify a problem before enforcers come in.," Scott said. "When an audit program weakens, this motivation is reduced, and the impact of this will eventually be reflected in a lower number of requests for voluntary closing agreements."

The IRS provided numbers, but not comments for this story.

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