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IRS Rules Against Fla. CDD.

In a precedent-setting decision that could have major ramifications for issuers, the Internal Revenue Service has ruled a Florida Community Development District is not a political subdivision that can issue tax-exempt bonds.

The decision, made in a 12-page technical advice memorandum the IRS' chief counsel's office sent to the Villages CDD on May 30, means that approximately \$364 million of its bonds could be declared taxable. It also threatens the tax-exempt status of bonds issued by thousands of organizations with similar structures around the country.

Capping a five-and-a-half year long examination, the IRS said that the Villages CDD board was controlled by the private developer for many years while the bonds were issued and was therefore not a political subdivision under Section 103 of the Internal Revenue Code.

"The mere delegation of sovereign power is not sufficient to create a political subdivision," the IRS said in the TAM. "If it were sufficient, then a clearly private entity with powers of eminent domain, including some railroads and utilities, could issue bonds without any political oversight."

"We believe that an entity that is organized and operated in a manner intended to perpetuate private control, and to avoid indefinitely responsibility to a public electorate, cannot be a political subdivision of a state," the IRS said.

Perry Israel, a lawyer based in Sacramento who is representing the CDD, said the district was disappointed in the TAM's conclusion and is concerned the IRS may be making new rules through the examination process.

Sources said the CDD has several options going forward including, settling with the IRS to preserve the tax-exempt status of the bonds, appealing to the agency's Office of Appeals, allowing the IRS to go after the bondholders who could in turn challenge the ruling in court, or seeking a legislative fix. The issuer does not have the ability to fight the IRS in a court, only taxpayers can do that, they added.

At least two lawmakers from Florida — Sen. Bill Nelson, a Democrat and Rep. Richard Nugent, a Republican — sent separate letters to the IRS ahead of its ruling urging the agency to consider the implications of any federal tax policy that might jeopardize the ability of CDDs to continue to issue tax-exempt municipal bonds in Florida. They worried about the potential harmful impacts on Florida homeowners already saddled by a weak economy.

The district is still considering its options, Israel said.

The IRS noted that the TAM, like other agency rulings for a particular issuer, may not be used or cited as precedent for other issuers. But for months, market participants have been warning that if the agency takes the view that the CDD is not a subdivision, this could potentially hurt scores of other CDDs and special districts.

There are nearly 580 CDDs operating in Florida alone that have been relying on the assumption that they are political subdivisions that can issue tax-exempt bonds.

“The IRS seems to be adding a new requirement for an issuer to be a political subdivision,” said Scott Lilienthal, president of the National Association of Bond Lawyers and a partner with Hogan Lovells US LLP. “That new requirement doesn’t seem to be based on any existing authority. If the IRS wants to revisit the definition of a political subdivision then it should do so through the formal rulemaking process and issue guidance on a prospective basis only.”

The Village Center CDD issued \$426.2 million of tax-exempt bonds from late November 1993 through June 1, 2004 to finance the acquisition of recreational and other facilities as well as a utility system for the Villages, a retirement community in Florida. The CDD is a commercial district encompasses more than 21,000 acres primarily located in Sumter County, Fla.

CDDs are authorized under Florida law to levy and collect special assessments to pay debt service on bonds and maintenance assessments to fund district operations.

Most recently the Villages CDD urged the IRS to end its audit after a review showed it didn’t overpay when purchasing four pieces of property with bond proceeds. The district said the valuations showed it had not been controlled by the developer.

by: JENNIFER DEPAUL