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NABL Says IRS Ruling Having Chilling Effect on Bonds.

The new position on political subdivisions that the Internal Revenue Service has taken in a bond-related tax dispute with a community development district in Florida has had a “chilling effect” on the issuance of such bonds and has hurt existing bond issues, bond lawyers are warning.

The National Association of Bond Lawyers made the warning in a letter sent to Treasury Department and IRS officials on Nov. 21. Accompanying the letter was a four-page memorandum explaining NABL’s opposition to the ruling and urging the agency and the Treasury Department to adopt new guidance containing a “safe harbor” for tax-exempt bond issuers.

The controversy is rooted in a 12-page technical advice memorandum dated May 9 that the IRS chief counsel’s office sent the Village Center Community Development District. The TAM, which wasn’t received by the CDD until June and wasn’t widely released until Aug. 23, concluded the district’s bonds were taxable because its board is, and will always be, controlled by private parties rather than publicly elected officials.

The CDD, a commercial development of about 167 acres of land in Lady Lake, Lake County, Fla. that provides security, fire, recreational golf and other services to residents of nearby districts, issued \$472 million of bonds.

In its TAM, the IRS chief counsel stated: “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.”

But NABL said in its letter that the TAM “is contrary to established legal authority.”

“The TAM has had an immediate chilling effect on the issuance of tax-exempt bonds by such issuers throughout the country and has raised questions in the market about outstanding bonds of such issuers, which may result in a loss in value of those bonds for current holders,” NABL said in the letter, which was signed by its president Allen Robertson.

NABL said that under the traditional legal analysis applied by the IRS, the courts and practitioners for many years, an entity is considered a political subdivision, with the right to issue tax-exempt bonds, if it is delegated the right to exercise substantial sovereign powers. These include the power to tax, the power of eminent domain and police power.

“A qualified issuer need not have all three powers but it must have more than an insubstantial amount of at least one of the sovereign powers,” NABL said.

The TAM, which focuses on the Village Center CDD’s responsibility to an electorate, calls into question whether districts with a limited number of property owners electors, or taxpayers may ever qualify as a political subdivision, the bond lawyers said.

The IRS supports its position in the TAM in part with IRS Revenue Ruling 83-131.

But NABL says the revenue ruling doesn't provide any support. The entities that were the subject of the revenue ruling were North Carolina electric and telephone membership corporations that provided utility services, NABL says. The revenue ruling notes that "the term political subdivision has been defined consistently for all federal tax purposes as denoting either a division of a state or local government that is a municipal corporation or ...that has been delegated the right to exercise sovereign power," The IRS concludes in the revenue ruling that the corporations do not qualify as political subdivisions in part because they do not have sufficient sovereign power.

NABL says the IRS appears to be concerned that private entities that exercise sovereign power, like railroads and utilities, could issue tax-exempt bonds without any political oversight. But CDDs are not private entities because they are created by and subject to the rules of governments, the bond lawyers said.

NABL asks the tax regulators to create a safe harbor under which an issuer will be a political subdivision if it meets three conditions. The first is that it is treated as a political subdivision under applicable state law. The second is that it has been delegated more than an insubstantial amount of the power of eminent domain, the power to tax or police power. The third is that, upon dissolution of the issuer, its assets are either distributed to, or directed by, a state or other political subdivision.

The memorandum and guidance was developed by an ad hoc task force made up of 12 NABL members. It was approved by the NABL board.

BY LYNN HUME