IRS Proposed Political Subdivision Rules Would Be Big Change for Munis.

WASHINGTON – The Internal Revenue Service is proposing new rules for political subdivisions issuing tax-exempt bonds that lawyers say will completely change the regulatory landscape and the way infrastructure has been financed in a number of states.

Under the proposed rules, which are slated to be published in the Federal Register on Tuesday, an entity is a political subdivision that can issue tax-exempt bonds if it meets a three-prong test. It must exercise sovereign powers, serve a governmental purpose, and be governmentally controlled. The requirement to be governmentally-controlled is new.

Historically, community development districts in Florida, metropolitan districts in Colorado, and rural utility districts in California and other states have been set up to issue tax-exempt bonds to finance public infrastructure such as roads, sewer and water systems for a variety of development projects. Initially the districts are controlled by developers, but as homes, business parks or shopping areas are built and irrigation systems are set up, that control is passed onto to users such as homeowners, businesses or farmers.

Now the IRS wants political subdivisions to be controlled by state or local governments or a group of elected officials that do not constitute a "private faction."

"This changing the landscape, it's such a change from how the rules were done before," said Vicky Tsilas, a partner at Ballard Spahr here and former associate tax legislative counsel at the Treasury Department. "But the good news is that they are only proposed and there's the ability to comment on them."

Tsilas noted that the proposed rules would restrict the financing of infrastructure at a time with the federal government is trying to promote it.

"This is a big shift in the law in many people's views," said Carol Lew a shareholder at Stradling Yocca Carlson & Rauth in Newport Beach, Calif. "Some of the tests – the three-prong test – are going to be difficult to apply, particularly for small districts such as small irrigation districts" where there may only be three famers that own the land.

"I think it will surprise the IRS as to how many districts are potentially affected by these," said Perry Israel, a lawyer with his own practice in Sacramento, Calif. who represents the Village Center Community Development District in Florida in a current dispute with the IRS that served as the impetus for these proposed rules.

The proposed rules would take effect beginning 90 days after they are finalized. However, they would not apply to existing tax-exempt bonds or to refundings that do not extend the maturities of the underlying bonds. Also, there would be a three-year transition period, under which entities in existence "prior to 30 days after the proposed rules are published" could continue to issue tax-exempt bonds while restructuring to comply with the new rules.

Comments on the new rules and requests to speak at a June 6 public hearing are due by May 23.

Dee Wisor, an attorney at Butler Snow in Denver, said the transition rule might cause a “rush to market” to issue tax-exempt bonds or refunding bonds for existing political subdivisions. He said the infrastructure in these developments has been financed in part with five- to seven-year bank loans with the intent of replacing the short-term loans with longer term tax-exempt bonds. But this wouldn’t comply with the restrictions on refundings.

“If they’re saying a developer can’t form a district and issue tax-exempt bonds, that’s going to be a big deal,” Wisor said.

In a section of the proposed rules called “Possible Relief for Development Districts,” the IRS asked for public comments on whether development districts should be political subdivisions during an initial development period in which one or two private developers could elect the district’s governing body and no other government control exists.

“The Treasury Department and IRS recognize that the governmental control requirement may present challenges for [some] development districts,” the agencies said, adding that they are “concerned about the potential for excessive private control by individual developers, the attendant impact of excessive issuance of tax-exempt bonds, and inappropriate private benefits form this subsidy.”

Lawyers and other market participants have been seeking guidance on the definition of a political subdivision ever since the IRS issued a very controversial technical advice memorandum in 2013. The TAM concluded 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.

Lawyers argued that the notion that control by elected officials is necessary for an entity to be a political subdivision is a new requirement and that such changes should be made through regulatory proposals that can be commented upon rather than through a TAM. Historically, the determination of whether an entity was a political subdivision was based on whether it had the right to exercise substantial sovereign powers, such as the power to tax for services, they said. The IRS has since said the TAM would not be retroactively applied.

In its proposed rules on political subdivisions, the IRS would provide at least three benchmarks of rights or powers that constitute control. These would be the right or power: to both approve and remove a majority of an entity’s governing body; to elect a majority of the governing body of the entity in periodic elections of reasonable frequency; and to approve or direct the significant uses of funds or assets of the entity in advance of those uses.

Aside from these three arrangements, the determination of whether a collection of rights and powers constitutes control would depend on facts and circumstances. Control of an entity by a small faction of private individuals, businesses or corporations, trusts, partnerships or other persons “is fundamentally not governmental control,” the IRS said.

Therefore the proposed rules would generally require that control be vested in either a general purpose state of local governmental unit or in an electorate established under an applicable state or local law of general application.

The IRS provides two facts and circumstances tests that serve as brackets to determine if there is governmental control. On one hand, the number of private persons controlling an electorate “is always unreasonably small" if the combined votes of the three voters with the largest share of votes determine the outcome of an election, regardless of how the other voters vote, the agency said.

On the other hand, the number of private persons controlling an electorate "is never unreasonably small" if determining the outcome of an election requires the combined votes of more voters than the 10 with the largest share of votes. "For example, control can always be vested in any electorate comprised of 20 or more voters that each have the right to cast one vote in an election without giving rise to a "private faction," the IRS said.

The proposed rules would place more emphasis on the fact that an entity must serve a governmental purpose to be a political subdivision. "Arguably, this was there before," Israel said. "This puts more emphasis on it."

Finally, the rules would maintain the existing longstanding requirement that a political subdivision be empowered to exercise a substantial amount of at least one of three generally recognized sovereign powers: eminent domain, or the power to take private property for public use, as well as the powers to police and tax.

THE BOND BUYER

BY LYNN HUME

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