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IRS Makes Political Subdivision Rules Prospectively Effective.

WASHINGTON - The Internal Revenue Service issued a "correction" on Wednesday that makes its proposed definition of political subdivision truly prospectively effective.

The six-page "correction," which will be published in the Federal Register on March 14, is expected to lessen the ire of bond lawyers meeting here on Thursday who were prepared to blast Treasury Department and IRS officials for the initial proposed effective date, which had not been prospectively effective despite assurances it would be.

"This is a clean, clear prospective effective date for bonds that are either existing or issued within 90 days after the final issue political subdivision rules are published in the Federal Register with regard to all tax-exempt bond provisions of the federal tax code," said John Cross, the Treasury Department's associate tax legislative counsel.

The same effective date applies to refundings of those bonds, as long as the refundings don't extend the maturities of the underlying bonds, he said.

Treasury and IRS officials had faced a firestorm of criticism from bond lawyers over the technically complicated first proposed effective date that would have been prospectively effective under certain tax-exempt bond provisions of the tax code, but not others. As a result, the prospective effective date would not have been prospective at all.

The correction means that the old political subdivision definition will apply to all existing bonds or those bonds issued within 90 after the final political subdivision rules are published, as well as to refundings of those bonds that don't extend maturities of the underlying bonds. Under the old definition, an entity is a political subdivision that can issue tax-exempt bonds if it has a delegated 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.

For existing political subdivisions that want to issue new tax-exempt after 90 days after the final rules are published, the old definition applies temporarily, but issuers have three years to reorganize to comply with the proposed new definition of political subdivision. New issuers that want to issue tax-exempt bonds must also meet the proposed new definition of a political subdivision.

Under the new definition, an entity is a political subdivision that can issue tax-exempt bonds if it meets a three-prong test. It must: be delegated the right to exercise a substantial amount of at least one of the three sovereign powers; serve a governmental purpose; and be governmentally controlled.

The IRS says the determination of whether an entity serves a governmental purpose is 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."

The IRS proposes 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.

Apart 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 or local governmental unit or in an electorate established under an applicable state or local law of general application. If, however, a small faction of private persons controls an electorate, the electorate's control of an entity does not constitute governmental control of the entity. Under the proposed rules, an entity controlled by an electorate is not governmentally controlled with the outcome of the exercise of control is determined solely by the votes of an unreasonably small number of private persons.

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 Bond Buyer

By Lynn Hume

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