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## **IRS Releases Proposed Regulations Defining a “Political Subdivision” For Purposes of Determining Eligibility to Issue Tax-Exempt Bonds: Butler Snow**

On February 22, 2016, the Internal Revenue Service (the “IRS”) released proposed treasury regulations (the “Proposed Regulations”) to provide guidance as to how the IRS intends to prospectively define a “political subdivision” for purposes of allowing political subdivisions to issue tax-exempt bonds under Section 103 of the Internal Revenue Code (the “Code”). The Proposed Regulations have not yet been enacted as “final” regulations, and accordingly, until the Proposed Regulations are finalized, the existing IRS guidance continues to control. The Proposed Regulations will mainly impact special districts formed by developers to provide infrastructure for new development.

The IRS has solicited comments to the Proposed Regulations and a public hearing is scheduled for June 6, 2016. As these Proposed Regulations, when finalized, will have a significant impact on many of Butler Snow’s clients, be assured that Butler Snow lawyers will be directly and actively involved with the preparation of comments on these Proposed Regulations directly with Treasury Department’s Chief Counsel’s Office, as well as through the National Association of Bond Lawyers and the American Bar Association.

Section 103 of the Code provides that interest on certain bonds issued by States and political subdivisions will be exempt from federal income tax. Traditionally, provided that a governmental entity possessed one or more substantial sovereign powers, including the power to tax, the power of eminent domain or the police power, the governmental entity was generally deemed to be a political subdivision, eligible to issue tax-exempt bonds under Section 103 of the Code. In 2013, however, the IRS issued Technical Advice Memorandum 201334038 (the “TAM”) which challenged traditional belief that a governmental entity possessing one or more substantial sovereign powers alone was enough to ensure the entity was in fact a political subdivision eligible to issue tax-exempt bonds. As a result of the TAM, there has been a great deal of uncertainty as to whether many of our special district clients qualify as political subdivisions, and ultimately, remain eligible to issue tax-exempt bonds under Section 103 of the Code.

The Proposed Regulations provide a new three-part test for determining whether an entity qualifies as a political subdivision, taking into account all of the relevant facts and circumstances, which includes:

1. The entity must possess the right to exercise a substantial amount of at least one sovereign power (the “Sovereign Power Test”);
2. The entity must serve a governmental purpose (the “Governmental Purpose Test”); and
3. A State or local government must exercise control over the entity (the “Control Test”).

Unlike the Sovereign Power Test and the Governmental Purpose Test, the Control Test is a substantial deviation from the current regulatory regime.

The Proposed Regulations define control, for purposes of the Control Test, as an ongoing right or power to direct significant actions of the entity and suggest the following significant rights or powers, on a discretionary and non-ministerial basis, will constitute control:

1. Right or power to elect a majority of the governing body of the entity.
2. Right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency.
3. Right or power to approve or direct the significant uses of funds or assets of the entity in advance of that use.

The Proposed Regulations further provide that control, for purposes of the Control Test, may be vested in one or both of the following:

1. State or local governmental unit possessing a substantial amount of each of the sovereign powers and acting through its governing body or through its duly authorized elected or appointed officials in their official capacities; or
2. An electorate established under applicable state or local law of general application, provided the electorate is not a “private faction.”

For this purpose, an electorate is a “private faction” if the outcome of the exercise of control is determined by the votes of an unreasonably small number of private persons. The Proposed Regulations provide that whether the number of private persons is unreasonably small will be determined based on all of the facts and circumstances, but also conclusively affirm that a private faction will always exist if the combined votes of three voters with the largest shares of votes can determine the outcome. The Proposed Regulations provide a safe harbor whereby a private faction will not exist provided a combined vote of more than 10 voters with the largest shares of votes in the electorate can determine the outcome. So, for example, an electorate with 20 voters, each with 5% equal voting power, would satisfy the safe harbor as 11 voters would be required to determine the outcome. In contrast, an electorate with 20 voters with unequal voting power in which 10 or few members could determine the outcome, would not satisfy the safe harbor.

The Proposed Regulations, if enacted as drafted, could have a significant impact on many Butler Snow clients. These Proposed Regulations are scheduled to be effective 90 days after publication in final form, with certain transition rules. It is likely that these Proposed Regulations will be modified to some degree following the comment process and public hearing, and therefore, it is unlikely they will be finalized as currently drafted. Please note, for all entities in existence prior to March 25, 2016, the Proposed Regulations would not be effective until three years and 90 days after publication in final form, presumably to give existing entities an appropriate amount of time to restructure and become compliant.

Of note to the development community is that the Treasury Department and IRS are seeking public comment on whether it is necessary or appropriate to permit special districts formed for new developments to be political subdivisions during an initial development period in which one or two private developers elect the district’s governing body and no other governmental control exists. The development community should consider commenting on the Proposed Regulations to make clear how important this tool is to new development.

As mentioned above, Butler Snow lawyers will continue working with IRS, the National Association of Bond Lawyers and the American Bar Association to ensure that the concerns of our Butler Snow clients are represented.

**Butler Snow LLP**

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