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Redefining 'Special Districts' Could Have Big Taxing Consequences.

If the IRS gets its way, it may be harder for special districts to issue tax-exempt municipal bonds.

Special districts spend more public money than all city governments combined, much of it raised through borrowing in the municipal bond market. But proposed new regulations from the Internal Revenue Service could make it harder for special districts to borrow that money tax-free. And that could be very expensive for states and localities.

All totaled, the Census Bureau counts 39,000 special-purpose district governments, which are usually created to address — and raise revenue for — specific functions, such as airports, libraries, wastewater, mosquito control and so on. They exist separately from general-purpose governments, and may cross the borders of cities, counties and states.

In order to issue tax-exempt bonds, an entity has to meet the definition of a municipality. In many ways, special distrcits do not. They aren't like traditional state or city entities at all. As creatures of the state, special-purpose districts have governing boards as determined by state law. But those boards may be appointed by public officials or by private entities. Or they may be elected by property owners within the special district — even though there may be only one or two residents, or in some cases, zero residents, to participate in a board election. While most special-purpose districts have employees, some don't, distinguishing them from every other kind of government in the country.

So if these entities don't resemble traditional state and local governments, why should they be allowed to borrow in the same tax-exempt way? That's just what the IRS wants to know. In February, the agency proposed regulations that would more clearly define the difference between a municipality and a special district. It may seem like a fine point, but in fact there's big money at stake. Special districts could see a nearly 30 percent increase in the costs of borrowing, which could work out to about $700 billion. It could be prohibitive enough to force many special districts out of existence.

Up until now, the IRS has defined a political subdivision — that is, any entity that's allowed to issue municipal tax-free bonds — by using a three-prong test. If an entity is authorized by the state to exercise at least one of three sovereign powers — the power of taxation, the power of eminent domain, or police power — then it qualifies to issue bonds tax free.

Under the proposed rule, those old tests of sovereign power still apply. But the new regulations would add another criterion: An entity must serve a governmental purpose and be governmentally controlled. That means that in order for a district to issue tax-free bonds, it must be controlled either by a general-purpose state or local government or by an electorate established by state or local law.

In short, the IRS has cast itself into the difficult role of defining when, and under what circumstances, there can be special districts (other than school districts, which wouldn't be affected by the new rule). Sussing out the definitions of 39,000 different districts would be a Herculean task, and it raises fundamental questions about just how we define government.

If finalized — and that decision won’t be made for months — the new rules may cause special districts in some states to lose their right to issue tax-exempt municipal bonds, which could have huge taxing and governing consequences for states and localities.

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