Bond Case Briefs

Municipal Finance Law Since 1971

Why Groups Are Demanding IRS Withdraw Proposed Political Subdivision Rules.

WASHINGTON – Municipal market participants are urging the Treasury Department and Internal Revenue Service to withdraw their proposed rules on political subdivisions, claiming they are unnecessary, possibly illegal and would disrupt the municipal bond market.

The National Association of Home Builders warned that if the proposed rules are adopted, they "could spark legal challenges" that create uncertainty in the market.

Historically, the determination of whether an entity was a political subdivision was based on whether it had the right to exercise a substantial amount of at least one of three sovereign powers: eminent domain, taxation, and policing.

But IRS officials, through audits, learned some developers had created political subdivisions and were in complete control of them, issuing tax-exempt bonds partly for their own benefit.

After an unsuccessful attempt to change the definition through the audit process, the Treasury and IRS proposed new rules in February that would add two new additional requirements, besides the sovereign powers one, to the definition of political subdivisions. They also would have to serve a government purpose "with no more than an incidental private benefit" and they would have to be governmentally controlled.

The rules had been retroactive, but following an outcry, Treasury and the IRS made them prospective. Political subdivisions would three years to comply with them and if they don't, they would no longer be political subdivisions and would no longer be able to issue tax-exempt bonds.

But the proposed rules have continued to draw strong opposition from muni market groups and participants.

In a May 23 letter, Securities Industry and Financial Markets Association managing director Michael Decker told IRS and Treasury that their position in the proposed rules "is not supported by existing legal authority" and that the proposed rules' departure from a longstanding principle used to evaluate political subdivisions is "unwarranted" and would be "disruptive to the market."

"We believe the federal government should not attempt to define a federal standard for what constitutes a governmental purpose," SIFMA wrote. Rather, this issue should be determined by state or local law, the group told the agencies.

"The new standard would substantially hinder financing of significant infrastructure needs in many states and local governments due to increased costs to issuers," SIFMA wrote. The higher costs would come from issuers having to use taxable instead of tax-exempt bonds to finance many projects or from the market demanding a risk premium from bonds due to the uncertainty created by the rules, it explained.

"For these reasons, we urge the [IRS] to withdraw the proposal," SIFMA wrote.

In a letter sent to the agencies on the same date, Bond Dealers of America also called for the rules to be withdrawn. Mike Nicholas' BDA's chief executive officer urged the proposed rules to be replaced with a new set that are more targeted to the IRS' concerns.

BDA said the proposed rules are "overly prescriptive" and that the government purpose section of them "will likely have a chilling effect on development projects."

"The proposed government control section introduces a new federal standard that BDA does not believe is necessary and will result in a market disruption as states have to adjust from sound, legal structures to a federally mandated political subdivision structure," the group wrote.

"The proposed rule[s] would unnecessarily disrupt the ability of projects serving the public interest, including hospital, school, road, water, sewer, gas, and electric projects to access the tax-free debt capital markets in the future," BDA said. It also would "cause significant confusion amongst issuers, legal professionals, underwriters, and investors about the current tax status and investment quality of the outstanding issuances of political subdivisions."

"These destabilizing factors outweigh the potential benefits of the proposal as drafted," the group wrote.

The Government Finance Officers Association also wrote the agencies on Monday, asking them to withdraw the rules and rewrite them "to directly address the specific types of abuses the IRS believes to exist."

"If the IRS and Treasury are concerned with new development districts as political subdivisions or perceived abuses within the current districts as they related to tax-exempt bond issuances, [they] should more carefully develop parameters to combat these real areas of concern rather than completely disrupt states' rights to create these entities and create roadblocks that would hinder [their] ability … to effectively, efficiently and economically serve communities," GFOA wrote.

The issuers' group told the agencies it objects to the proposed regulations "due to the far-reaching scope and negative impact to political subdivisions across the U.S." There are 38,572 special districts in the U.S., according to the 2012 U.S. Census of Governments. "These entities serve a purpose that is in the best interest of the particular state by which they are created and whose governing body has approved their existence," GFOA wrote.

These districts have the ability to issue tax-exempt bonds to help fulfill their purposes, the group added. State and local authorities in 2015 issued $177 billion on bonds, nearly half of the $404 billion issued that year, according to Thomson Reuters data that GFOA cited.

Florida Gov. Rick Scott told the agencies on Monday that his state is home to about 500 community development districts (CDDs), mostly created for residential projects and governed by state law, that have issued more than $12 billion of bonds to fund public infrastructure since the 1990s.

"Any change to the ability of Florida's governments to issue tax-exempt bonds could have severe consequences for hundreds of thousands of Floridians and for the Florida economy, which is growing and vibrant again after one of the worst real estate recessions in history," Scott wrote. "The proposed regulations also run contrary to the current stated Obama administration policy of finding solutions to solve our country's infrastructure needs."

Scott told the agencies that special districts, like CDDs, "have been a cornerstone of Florida's growth and development for nearly 100 years." They are, and have always been "creatures of Florida law," he added.

"The ability of CDDs and other local governments to continue to issue tax-exempt municipal debt for public improvements and services is vital to Florida's economic growth," Scott wrote. "I am committed to doing everything possible to ensure that Florida stays on its current path of economic prosperity," he added, sending the letter to the states U.S. congressional delegation.

The National Association of Home Builders told the agencies that the proposed rules would "have far-reaching negative consequences for local communities and their residents, particularly in states that rely on development districts to finance the services needed to support new residential construction in the face of constrained municipal revenues."

NAHB said the proposed rules are unnecessary based on available case law and congressional intent" and warned they could "spark legal challenges that would result in additional uncertainty."

The National Association of Bond Lawyers told the agencies that the proposed rules are the result of the IRS position in audits of two CDDs in Florida – the Village Center CDD and the Sumter Landing CDD.

"There has been no independent development in the market or a change in the law that needed to be addressed, but rather only this instance of the IRS' position in an examination causing significant uncertainty and disruption in the financial market and legal community," NABL wrote, adding, "The IRS created the legal issue that the proposed regulations now seek to solve."

As a result of the audits of the bonds of these CDDs, the IRS chief counsel issued a technical advice memorandum in May 2013 that concluded the Village Center CDD is not a political subdivision because its board is, and will always be, controlled by a private developer rather than by residents or other publicly elected officials. Under the TAM, millions of dollars of tax-exempt bonds issued by the CDD would become taxable.

But bond lawyers fought against the TAM, arguing it was an attempt to change existing standards retroactively through enforcement rather than prospectively through rulemaking, which gives market participants a chance to provide input. Eventually the TAM was made prospectively effectively and the IRS resorted to rulemaking and issued these proposed rules.

NABL cited a 1981 ruling by the U.S. Court of Appeals for the Third Circuit in Philadelphia National Bank v. U.S., in which the court found Temple University was not a political subdivision because it did not have a significant amount of any of the three sovereign powers: eminent domain; taxation and policy power.

"This standard was straightforward and easily applied for decades," NABL told the agencies, referring to it as the "Shamberg rule." This rule should continue to be the sole standard for political subdivisions, the bond lawyers group added.

NABL also wrote that the proposed rules "are not administrable" and would "create significant new burdens on governmental organizations seeking to qualify, or maintain qualification, as political subdivisions."

The group included in its comments a one and half page analysis that entities would have to go through to determine if they comply with the proposed rules.

The bond lawyers group also warned that the proposed rules would have many unintended consequences, some outside the federal income tax law.

For example, NABL wrote, if an entity failed either of the three tests in the IRS proposed rules – sovereign powers, governmental purpose and governmental control – “not only could it not issue tax-exempt bonds, but its use of bond-financed facilities would constitute private use and may, therefore be shut out from government borrowing programs such as the state clean water revolving loan programs.” The entity also could be liable for federal income tax on its taxable income that it didn’t have to previously pay because of a tax provision, according to NABL.

The Bond Buyer

By Lynn Hume

May 23, 2016