Bond Case Briefs

Municipal Finance Law Since 1971

Why IRS Dropped its Challenge to Florida CDD Bonds.

WASHINGTON – The Internal Revenue Service has closed audits and left the tax-exempt status unchanged for $311.28 million of community development district bonds in Florida that started a huge debate about political subdivisions and led the tax agency to propose controversial rules for such districts earlier this year.

More than $246 million of the bonds were issued by the Village Center CDD in 1998, 1999, 2001, 2003 and 2004, but were redeemed in November 2014. Another $65 million of bonds were issued by the Sumter Landing CDD were issued in 2005 but were redeemed in October 2015.

In separate letters to each CDD, the IRS noted the bonds were redeemed and said, "We have concluded that closing this examination without further IRS action supports sound tax administration."

The IRS actions close the book on long standing audits that sparked a huge ongoing debate between the tax agencies and municipal market participants over how to define political subdivisions that can issue tax-exempt bonds. These two CDDs – commercial districts for a retirement community with more than 100,000 residents in two counties — were organized as political subdivisions under Florida law. The IRS challenged their status in audits, but has now dropped the challenges and closed the audits.

Perry Israel, a lawyer with a private practice in Sacramento who is representing the Village Center CDD, and Richard Chirls, a lawyer with Orrick, Herrington & Sutcliffe in New York City who is representing the Sumter Landing CDD, each said they and their clients are pleased the examinations have been closed.

"They're absolutely right," said Israel. "It's a poor use of IRS resources to continue to go after these bonds when they've been paid off for almost two years."

The Village Center "did taxable refundings [of the bonds], but was still able to reduce its borrowing costs," he added.

Israel said that he believes the audit of the Village CDD, which began in January 2008 and took more than 8 ½ years to complete, may have been the longest examination ever done in the muni market. Some of those same bonds had also been the subject of an earlier audit that was closed in January 2003 which would make the examination of them even longer.

The IRS was on a slower track with Sumter Landing, but Chirls said, "This is simply an examination that went on much too long. It was, in the end, a waste of resources, staff, administrative time, and actual dollars by the district and the IRS."

Some muni market participants said the IRS may have been willing to close the audits, realizing they were a drag on resources while the agency was up against a statute of limitations problem. Generally, the IRS can go after taxpayers for payment of taxes due to violations of tax laws or rules

three years from the later of the date that taxes are due or the date that taxes are paid.

The Village Center bonds were redeemed in 2014 meaning the latest date a full year of interest would have been 2013, with tax returns to be filed in April 2014. Three years after that would be in April of next year. With this year more than half over, the IRS had still not declared the CDD's bonds taxable and, if it had, the CDD would have had an opportunity to appeal that finding and go through a lengthy appeals process.

It seems odd that the IRS closed the audits without accepting a payment for settlements. The two CDDs earlier this year told the IRS they would settle the tax dispute for $300,000, the amount they estimated would be the legal fees they would have to pay to continue fighting the IRS. The IRS, which had been pushing for a $1.5 million settlement, never took them up on the offer.

Also, the IRS letters sent to the CDDs are odd in two respects. Both letters said the CDDs were sent Forms 5701, Notices of Proposed Adjustments. But these forms, which notify taxpayers of increased tax liabilities, are not used in the municipal market, bond lawyers said. The CDDs actually received Forms 5701-TEB, or Notices of Proposed Issue that notified them the IRS had preliminarily determined the bonds were taxable.

In addition, the IRS letter to the Village Center CDD noted the agency found the CDD was not a "proper issuer of tax-exempt bonds" and the bonds were private-activity bonds that did not fall in any of the categories that qualify for tax-exemption. The one sent to the Sumter Landing CDD said only that the IRS found the bonds were taxable PABs.

The IRS may not have said that Sumter Landing CDD was not a proper issuer, because it was only the Village Center that received a technical advice memorandum from the IRS chief counsel's office in May 2013. That TAM said the CDD was not a proper issuer of tax-exempt bonds because its board was and would always be controlled by a developer rather than by residents or others responsible to a public electorate.

However, after an outcry from issuers and bond lawyers that the IRS was trying to change rules retroactively through enforcement actions, the IRS made the TAM prospectively effective. That means the TAM shouldn't apply to either the Village Center CDD or the Sumter Landing CDD.

The TAM led the Treasury Department and IRS to propose rules in February of this year that would dramatically change the definition of a political subdivision.

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.

Community development districts in Florida, metropolitan districts in Colorado, rural utility districts in California and districts in other states for years 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, the control of boards is passed onto to residents or users such as homeowners, businesses or farmers.

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

The proposed rules would add two new additional requirements, besides the sovereign powers one,

to the definition. Political subdivisions would also have to serve a government purpose “with no more than an incidental private benefit” and would have to be governmentally controlled.

“The IRS is now properly addressing the perceived problems through a regulatory process that includes proposals, comments and a prospective effective date,” said Chirls.

But the proposed rules have taken a beating from municipal market groups and individuals who have sent the IRS more than 130 comment letters slamming them.

The Bond Buyer

by Lynn Hume

July 19, 2016

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com