

IRS RELEASES PROPOSED POLITICAL SUBDIVISION REGULATIONS

On February 23, 2016, the Internal Revenue Service issued proposed regulations (REG-129067-15, the “Proposed Regulations”) revising the definition of political subdivision for the purpose of tax-exempt bonds. The Proposed Regulations follow a controversial 2013 IRS Technical Advice Memorandum (the “TAM”) that concluded that bonds issued by a Florida community development district were not tax-exempt because the district was not a political subdivision eligible to issue tax-exempt bonds. Like the TAM, the Proposed Regulations adopt a narrower definition of political subdivision than has typically been used by the tax-exempt bond community.

Under Section 103 of the Internal Revenue Code, gross income does not include interest on “State or local bonds.” The Proposed Regulations state that a State or local bond is any obligation of a State or political subdivision thereof.¹

Under Treasury Regulation 1.103-1 (the “Existing Regulations”), a political subdivision is any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

If finalized, the Proposed Regulations would replace the Existing Regulations and add to the eligibility requirements for a political subdivision. Under the Proposed Regulations, a political subdivision (whether or not incorporated as a municipal corporation) must meet three requirements: sovereign powers, governmental purpose, and governmental control. As under the Existing Regulations, the

sovereign powers include the police power, the power of taxation and the power of eminent domain. The entity must be able to exercise a substantial amount of at least one of these powers to be considered a political subdivision for the purpose of issuing tax-exempt bonds.

The Proposed Regulations also require that a political subdivision serve a governmental purpose. A governmental purpose requires, among other things, that the purpose for which the entity was created, as set out in its enabling legislation, be a public purpose and that the entity actually serve that purpose. It also requires that the entity operate in a manner that provides a significant public benefit with no more than incidental benefit to private persons.

The third requirement in the Proposed Regulations is that a political subdivision must be governmentally controlled. This requirement does not appear in the Existing Regulations and is likely to generate substantial comments from the tax-exempt bond community. Under the Proposed Regulations, a State or local governmental unit must exercise control of the entity. Control is defined as an ongoing right or power to direct significant actions of the entity. Control includes the right or power both to approve and to remove a majority of the governing body of the entity; the right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency; or the right or power to approve or direct the significant uses of funds or assets of the entity in advance of that use. In contrast, imposition of requirements for submission of audited financial statements to a higher level State or local governmental unit, open meeting requirements, and conflicts of interest limitations do not constitute control.

Under the Proposed Regulations, control of a political subdivision must be vested in: (A) a State or local governmental unit possessing a substantial amount of each of the sovereign powers and acting through its governing body or

¹ Obligations issued by or on behalf of any State or local governmental unit by a constituted authority empowered to issue such obligations are the obligations of such a unit. An obligation qualifies as a State or local bond so long as the issuer of that obligation remains a State or local governmental unit or a constituted authority.

through its duly authorized elected or appointed officials in their official capacities; or (B) an electorate established under applicable State or local law of general application, provided the electorate is not a private faction. If the electorate has an unreasonably small number of private persons it is a “private faction.” The Proposed Regulations provide that an electorate is a private faction if the combined votes of the three voters with the largest shares of votes in the electorate will determine the outcome of the relevant election regardless of how other voters vote. The Proposed Regulations also provide that an electorate is not a private faction if the smallest number of private persons who can combine votes to establish a majority of the votes necessary to determine the outcome of the relevant exercise of control is greater than ten persons.

As the preambles to the Proposed Regulations note, the governmental control requirement is likely to present challenges for certain development districts where a small number of developers may control the district for an initial development period. The Treasury Department and IRS are seeking public comment on whether it is necessary or appropriate to permit such districts to be political subdivisions during an initial development period; how such relief might be structured; what specific safeguards might be included in the recommended relief to protect against potential abuse; and whether the proposed prospective effective dates and transition periods in the Proposed Regulations provide sufficient relief.

The Proposed Regulations generally would apply to all entities for all purposes of the tax-exempt bond provisions of Sections 103 and 141 to 150 of the Internal Revenue Code beginning 90 days after the Proposed Regulations are finalized. However, the Proposed Regulations include transition rules under which the definition of political subdivision will not apply (1) for determining whether outstanding bonds are obligations of a political subdivision; and (2) to existing entities for a transition period.

A public hearing is scheduled for June 6, 2016 at 10:00 AM at the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, D.C. Comments and requests to speak must be submitted by May 23, 2016.

The Proposed Regulations are available for download on the [Federal Register website](#).

Pacifica’s public finance team is reviewing the Proposed Regulations for potential impact on our clients. For further information about the Proposed Regulations, please consult tax partner Alison J. Benge.

This client alert is intended as an information source for the clients and friends of Pacifica Law Group. The content should not be construed as legal advice, and readers should not act upon information in the publication without professional counsel. This material may be considered advertising under certain rules of professional conduct.

Copyright © 2016 Pacifica Law Group, LLC. All rights reserved.

Dated: February 25, 2016