

INSIGHTS

Proposed Regulations Could Have a Substantial Effect on Special District Issuers, Especially Developer Districts

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In an important development for special districts, including water districts, road districts, and other utility districts, on February 22, 2016, the Internal Revenue Service (“IRS”) released proposed Treasury Regulations (the “Proposed Regulations”) revising guidelines for what is a “political subdivision” for purposes of issuing tax-exempt bonds. As described in greater detail below, an entity would have to meet three requirements: (i) sovereign powers, (ii) governmental purpose, and (iii) governmental control. Finalization of the Proposed Regulations generally should not have an effect on traditional governmental issuers, such as cities, counties, school districts and state agencies. However, if finalized, the Proposed Regulations would have a significant impact on the ability of certain entities, such as many special districts, that are statutorily created and may have a limited electorate.

Industry participants have awaited guidance on the definition of “political subdivision” since 2013, when the IRS issued a controversial technical advice memorandum (the “TAM”) that many in the public finance community claimed undercut the longstanding practice of relying on whether the entity in question was empowered to exercise at least one of the three sovereign powers – eminent domain, taxing authority, and policing power – by adding a new requirement that the entity be accountable to a general electorate. Recognizing that the approach taken by the TAM would affect many issuers with existing issues of bonds outstanding, some in the public finance community argued that any change should be fully vetted through the regulatory or legislative process, where there would be an opportunity for public input. The Proposed Regulations are a response to this criticism, albeit one that we predict will generate significant critical review. Those who wish to provide comments regarding the Proposed Regulations must do so by May 23, 2016.

Sovereign Powers

The Proposed Regulations continue the longstanding requirement that to be a “freestanding” political subdivision, an entity must be empowered to exercise a substantial amount of at least one of the three generally recognized sovereign powers: (i) eminent domain, (ii) taxing authority, and (iii) policing power.

Governmental Purpose

Introductory background to the Proposed Regulations observes that case law and IRS guidance have traditionally analyzed whether an entity seeking political subdivision characterization

serves a public purpose by focusing on the purpose for which the entity was created, usually as set forth in the legislation authorizing its creation, rather than the entity's conduct after its creation. The Proposed Regulations appear to expand on this analysis by requiring an entity to serve a governmental purpose, the determination of which will be based on *"among other things, whether the entity carries out the public purposes that are set forth in the entity's enabling legislation and whether the entity operates in a manner that provides a significant public benefit with no more than incidental private benefit."* (emphasis added).

Governmental Control

The most significant proposed change introduced by the Proposed Regulations is that satisfaction of an explicitly defined governmental control requirement will be necessary to achieve political subdivision status. The Proposed Regulations provide rules for determining both what constitutes control and which parties must possess the control for this requirement to be met. The existence of statutory or case law authority for adoption of these elements of the Proposed Regulations is likely to be the subject of considerable debate.

Specifically, the Proposed Regulations define "control" to mean *ongoing rights or powers to direct significant actions of the entity*, and set forth three non-exclusive benchmarks of rights or powers that constitute control (as well as identifying what does not constitute control, including the right to dissolve the entity).

In addition to defining control, the Proposed Regulations also require that control be vested in either a general purpose State or local governmental unit (e.g., a State, city or county) or in an electorate established under an applicable State or local law of general application, *provided the electorate is not an unreasonably small number of private persons*.

The Proposed Regulations state that the number of private persons controlling an electorate *is always unreasonably small 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 the other voters vote. Conversely, the number of private persons controlling an electorate *is never unreasonably small if determining the outcome of the relevant election requires the combined votes of more voters than the 10 voters with the largest shares of votes in the electorate*. For purposes of applying these measures, "related parties" (as defined in the Internal Revenue Code) are treated as a single voter and the votes of the related parties are aggregated.

For example, if an electorate consists of 20 unrelated private persons with equal, five percent shares of the total votes, that electorate is not "unreasonably small" because a minimum number of 11 members of that electorate is necessary achieve a majority of the votes. On the other hand, if a district had five families of five people (all of whom are of voting age) for a total electorate of 25, the electorate would be considered unreasonably small because under the "related party" rule, each family would be considered one voter and three families could control the outcome. The Proposed Regulations appear to leave open the governmental control question where voting control consists of more than three but less than ten "voters."

Effective Date

If adopted in final form, the Proposed Regulations would become effective beginning 90 days after the final version is printed in the Federal Register, subject to certain transitional rules (including transitional rules that exclude application to existing bonds or refunding bonds that do not increase the amount or maturity of the refunded bonds). However, issuers may elect to

prospectively apply the definition of political subdivision in the Proposed Regulations if they so choose, subject to certain consistency rules.

Requests for Comments and Public Hearing

The preamble to the Proposed Regulations notes that the governmental control requirement may present challenges for certain development districts that issue bonds during an initial development period in which a small number of private developers elect the district's governing body and no other governmental control exists. In that regard, the IRS is 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 transitional periods in the Proposed Regulations provide sufficient relief. ***Written comments must be submitted by May 23, 2016, and a public hearing is scheduled for June 6, 2016.***

For more information regarding the Proposed Regulations and their impact on specific situations, please contact [Brian Teaff](#). Click [here](#) for the text of the Proposed Regulations.