Proposed IRS regulations could disqualify issuers

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Categories:

Publications

On May 23, the Treasury Department received a flurry of comments from various organizations regarding proposed regulations that alter the definition of a political subdivision. Almost 100 comments were submitted. National organizations such as the National Association of Bond Lawyers; National League of Cities; National Association of Counties; U.S. Conference of Mayors; International City/County Management Association; and International Municipal Lawyers Association, among others, chimed in. Individual governors, law school professors and various other interested parties all had something to say about the proposed regulations.

Background

So what is the big issue? Earlier this year, the Internal Revenue Service issued proposed regulations under Code section 103. These proposed regulations purport to clarify the definition of "political subdivision." They will affect state and local governments that issue tax-exempt bonds and users of property financed with tax-exempt bonds.

Code section 103 provides that, subject to some exceptions not relevant here, gross income does not include interest on any obligation of a State or political subdivision thereof. Section 1.103-1 of the existing Treasury Regulations defines a political subdivision as "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." It was widely understood by practitioners that a public entity could qualify as a political subdivision if it had the power to tax or could exercise eminent domain or regulatory / police powers. Such an entity would qualify as a political subdivision and therefore could issue tax exempt bonds or use tax-exempt financed facilities.

Then, as it often does, through informal channels, the Service imposed additional requirements on the definition of a political

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subdivision. Through a tax advice memorandum (TAM), the Service focused on the term "any division of any state or local governmental unit" and ruled that additional requirements were needed to meet the definition of a political subdivision. Surprisingly, not, the Chief Counsel's office agreed. After commenters requested additional published guidance, to be applied prospectively, on the eligibility requirements to be a political subdivision, the Service issued proposed regulations. Unfortunately, the proposed regulations went **much further** than the existing guidance and even the TAM.

The proposed changes

Under the proposed regulations, in addition to being delegated a sovereign power, the entity must have a **governmental purpose** and also be under **governmental control**. To determine whether an entity has a governmental purpose, existing guidance requires you to look at the organizing documents to determine whether the entity was formed for a public purpose. The proposed regulations impose an additional requirement to look at, not only the organizing documents, but how the entity operates. The entity must be operated for a public purpose with only incidental benefit to private persons. If an entity fails to operate in such a manner for the entire time the obligations are outstanding, then the tax exempt status of the obligations will be in jeopardy.

The governmental control requirement is entirely new and the most troubling. This new requirement provides that a political subdivision must be controlled by a state or local governmental unit or an electorate. Control is defined to mean ongoing rights or powers to direct signification actions of the entity. Three benchmarks were provided to clarify control: the right or power to approve **and** remove a majority of an entity's governing body; the right or power to elect a majority of the governing body of the entity in period elections of reasonably frequency; or the right or power to approve or direct the significant uses of fund or assets of the entity in advance of such use. Without one of these three benchmarks, specific facts and circumstances determine whether control exits. The control must be exercised by a state or local government acting through its governing body or through its duly elected or

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appointed official. Thus, an entity with a governing board appointed by multiple local governments would fail the control test. Alternatively, control can be exercised by a public electorate, so long as the electorate is not a private faction. What is a private faction? An unreasonably small number of private persons. Three people who can make up a majority of the vote is unreasonably small. Conversely, more than 10 is not. Otherwise, a private faction depends on the facts and circumstances.

What happens next?

These proposed regulations can impact thousands of issuers. Fortunately, they are only proposed at this point. The next step in the process is a public hearing currently scheduled for June 6, 2016. After such date, we will know the Service's response to the commentary. This response will be to do nothing and maintain the current regulatory regime, enact the proposed regulations as written (which many think is unlikely) or something in between. For more information, contact Lark T. Mallory in Frost Brown Todd's Public and Project Finance group.

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