KPMG
cutting through complexity

What's News in Tax
Analysis That Matters from Washington National Tax

Proposed Section 103 Regulations Could Muddy the Waters for Issuers of "Dirt Bonds"

Community development districts, established to develop or improve infrastructure on raw or blighted land, may issue tax-exempt bonds—often referred to as "dirt bonds" because the bonds typically are intended to be repaid from taxes imposed on land developed with the bond proceeds. This article considers how the tax landscape for dirt bonds might shift if recently issued proposed regulations are finalized.

June 6, 2016

by Paul Kunkel and Alexandra Mitchell, Washington National Tax

Paul Kunkel is a director in the Financial Institutions and Products group of Washington National Tax ("WNT"). Alexandra Mitchell is a director in the Exempt Organizations group of WNT.

On February 22, 2016, the IRS released proposed regulations (the "Proposed Regulations")[1] providing guidance on the definition of "political subdivision" for purposes of the rules governing tax-exempt bonds under section 103. While the guidance is consistent in most respects with criteria found in case law and many earlier rulings, the Proposed Regulations have already stirred controversy because they are based on the position taken by the IRS in a highly publicized technical advice memorandum issued during 2013 (the "2013 TAM").[2]

Background

Section 103(a) of the Code generally excludes from gross income interest on any "State or local bond."[3] For this purpose, section 103(c)(1) defines

---

1 REG-1290679-15, 81 Fed. Reg. 8,870 (Feb. 23, 2016); 81 Fed. Reg. 13,305 (Mar. 4, 2016) (correcting the scope of the transition rules).

2 TAM 201334038 (May 9, 2013). Pursuant to section 6110(k)(3), written determinations such as technical advice memoranda and private letter rulings represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and they are not intended to be relied upon by third parties and may not be cited as precedent. These written determinations do, however, offer an indication of the IRS's position on the issues addressed.

3 Section 103(b) defines exceptions for (1) private activity bonds that are not qualified private activity bonds within the meaning of section 141; (2) arbitrage bonds within the meaning of section 148; and (3) bonds that do not satisfy the registration requirements of section 149.

"State or local bond" to mean an obligation of a State or political subdivision thereof. Although section 103(c)(2) enlarges the meaning of "State" to include the District of Columbia and any possession of the United States, section 103 does not define "political subdivision."

Under case law, a political subdivision for purposes of section 103 is required to possess and exercise sovereign powers.[4] Current regulations similarly state that a political subdivision is a "division" of State or local government that exercises sovereign powers: "the term 'political subdivision,' for purposes of this section denotes 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."[5] Case law recognizes three sovereign powers: the power of eminent domain, police power, and taxing power. A political subdivision must be able to exercise a substantial amount of at least one of these powers.[6]

An entity created under a State or local enabling statute need not perform all or even a significant number of the essential governmental functions of a State government in order to be respected as a political subdivision for purposes of section 103. The regulations list as examples of political subdivisions "special assessment districts so created [i.e., to exercise part of a State's sovereign powers], such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit."[7] Although such limited purpose districts can and generally do serve legitimate public functions, the restricted geographic and functional scope of these entities, as well as the means by which they often are governed (e.g., a board elected or controlled by a small number of persons), can raise questions about whether local private interests control and operate these entities primarily for their own benefit rather than for the good of the general public.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

---

4 *See, e.g.,* Commissioner v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944); Philadelphia Nat'l Bank v. United States, 666 F.2d 834 (3d Cir. 1981); Commissioner v. White's Estate, 144 F.2d 1019 (2d Cir. 1944).

5 Section 1.103-1(b).

6 *Id.*; *see also* Rev. Rul. 77-164, 1977-1 C.B. 20; Rev. Rul. 77-165, 1977-1 C.B. 21.

7 Section 1.103-1(b).

Motivated by concern about how private interests might control and benefit from such limited purpose State and local governmental entities, the IRS has formulated and applied two additional requirements that an entity must meet in order to qualify as a "division" of a State or local governmental unit, and thus be treated as a political subdivision, for purposes of section 1.103-1(b). In addition to exercising sovereign powers, the entity must be operated for a governmental purpose and must be governmentally controlled. For example, in Revenue Ruling 83-131,[8] the IRS found that "electric and telephone membership corporations" formed under a North Carolina statute were not political subdivisions because the corporations were financially autonomous, not controlled by a State or local government, and not motivated by wholly public purposes. Although the specific question addressed in the revenue ruling was whether the electric and telephone membership corporations were political subdivisions for purposes of the sales tax exemption in section 4041(g)(2),[9] the IRS asserted that "the term political subdivision has been defined consistently for all federal tax purposes."[10] Subsequent to Revenue Ruling 83-131, the IRS has consistently stated in private letter rulings and other administrative guidance that political subdivisions for purposes of section 103 must exercise sovereign powers, serve a governmental purpose, and be governmentally controlled.[11] The Proposed Regulations explicitly incorporate the governmental purpose and control requirements as part of the definition of political subdivision.

---

8 1983-2 C.B. 184.

9 Section 4041(g)(2) provides that, under regulations prescribed by the Secretary, no sales tax is to be imposed under section 4041 with respect to the sale of any liquid for the exclusive use of any State, any political subdivision of a State, or the District of Columbia, or with respect to the use by any of the foregoing of any liquid as a fuel.

10 *Compare, e.g.,* Announcement 2011-78, 2011-51 I.R.B. 874 (defining "political subdivision" for purposes of section 414(d)) *and* the preamble to the Proposed Regulations (stating that "[t]he definition of political subdivision in the Proposed Regulations does not apply in determining whether an entity is treated as a political subdivision of a State for purposes of section 414(d)").

11 *See, e.g.*, PLRs 200017018 (Jan. 27, 2000), 200204032 (Jan. 25, 2002), 200238001 (Sept. 20, 2002); TAM 200646017 (Aug. 1, 2006).

The 2013 TAM

The IRS applied the reasoning of Revenue Ruling 83-131 in the 2013 TAM, determining that a community development district bond issuer (the "Issuer") was not a division of a State or local governmental unit for purposes of section 103 because it was not operated for public purposes and was not governmentally controlled.[12] While the IRS's application of these criteria in the 2013 TAM should not have been surprising in light of the previous line of rulings, the IRS's determination that the Issuer was not governmentally controlled because it was not "responsib[le] to a public electorate" was interpreted by commentators as unduly limiting the meaning of "governmental control."[13] Undaunted (or perhaps inspired) by this criticism, the IRS is understood to have begun work on the Proposed Regulations shortly after the issuance of the 2013 TAM.[14]

Under the facts of the 2013 TAM, the majority of the land within the Issuer's development district was owned directly or indirectly by a single individual (the "Developer") and his family, whose controlled corporation used the Issuer's bond proceeds to develop a retirement community.[15] Under the enabling statutes, the Issuer was governed by its own board of supervisors, initially elected by district landowners, with voting power generally based on acreage owned, and a majority vote controlling board decisions. However, beginning after a specified number of years and a

---

[12] Community development districts, or development districts, are special purpose local governmental entities established by statute typically for the purpose of developing or improving infrastructure on raw or blighted land. Bonds issued by community development districts are often referred to as "dirt bonds" because the bonds typically are intended to be repaid from taxes imposed on land to be developed with the bond proceeds.

[13] *See, e.g.,* E. Aprill, "Municipal Bonds and Accountability to the General Electorate," 2013 TNT 216-8 (Nov. 7, 2013).

[14] The 2013 TAM was issued on May 9, 2013; on August 9, 2013, the Treasury released its 2013-2014 Priority Guidance Plan, in which Treasury announced that it intended to provide guidance on the definition of political subdivision for purposes of section 103. *See also* "IRS Political Subdivision Proposal Could Be Controversial," 2016 TNT 35-6 (Feb. 23, 2016).

[15] The Issuer under examination in the 2013 TAM is understood to be Village Center Community Development District in Florida. *See, e.g.*, "IRS Rules Florida Development Bonds Should be Taxable," CNBC, June 6 2013, *available at* http://www.cnbc.com/id/100796689; "Fla. Village Center CDD Lawyer Blasts Ruling, Asks IRS to Reconsider," *The Bond Buyer*, July 18, 2013, *available at* http://www.bondbuyer.com/issues/122_138/fla-village-center-cdd-lawyer-blasts-ruling-asks-irs-to-reconsider-1053857-1.html.

certain number of residents becoming eligible to vote, the statute required the board to be elected by the eligible voters in a general election. Because the Developer owned most of the land in the district, the Issuer's board was initially controlled by the Developer.

In fact, the IRS found that the Developer and his family had controlled the Issuer's board at all times since the formation of the Issuer (more than 20 years) and that, during those years, the Developer had succeeded in changing the boundaries of the Issuer several times in order to ensure that there would not be enough eligible voters in the district to force the board election process to change. Although the Issuer argued that it was created to fulfill the public purpose of managing and financing basic community development services, and that it was "sufficiently controlled" by the State because certain of its financial and administrative procedures were subject to public access and disclosure, the IRS disagreed.

According to the IRS, the Issuer's obligations to abide by certain governmental reporting and administrative procedures did not mean that the Issuer was subject to governmental control, given that "[n]either the State nor local government participated in or had authority to overrule decisions of the Board, including decisions to purchase assets from the Developer whose owner controlled the Board." The IRS also dismissed the Issuer's contention that it was operated for a governmental purpose, finding instead that "[i]ndeed, the facts indicate that Issuer was intentionally structured to ensure that [control of the board by public elections] never could happen . . . [A]n entity that is organized and operated in a manner intended to perpetuate private control, and to avoid indefinitely responsibility to a public electorate, cannot be a political subdivision of a State."

It can be debated whether the circumstances under consideration in the 2013 TAM represented "bad facts" that can only inspire "bad law," or whether those facts were representative of community development districts in general, and thus require a regulatory response to end what might be a more widespread abuse of section 103. Whatever the reality, the public has now had the opportunity to comment on the provisions in the Proposed Regulations that appear to have been motivated by the IRS's experience with the 2013 TAM.

The Proposed Regulations

In response to requested guidance on which facts and circumstances are germane to an entity's status as a political subdivision, and in recognition of the need to clarify the definition of a political subdivision to provide greater certainty to prospective issuers and to promote greater consistency in the application of the definition, the Treasury Department and IRS released proposed regulations providing a new definition of a political subdivision. To qualify as a political subdivision under the Proposed Regulations, an entity must meet three requirements: (1) sovereign powers, (2) governmental purpose, and (3) governmental control.

Sovereign Powers

As previously discussed, the current regulations define a political subdivision with reference to the right to exercise sovereign powers.[16] The Proposed Regulations adopt this requirement without substantive change, requiring a political subdivision to be empowered to exercise a substantial amount at least one of the generally recognized sovereign powers: eminent domain, police power, and taxing power.[17]

Governmental Purpose

Although prior guidance from the courts and the IRS have required entities to demonstrate that they further a governmental purpose to qualify as a political subdivision, the current regulations do not include this requirement. Under the Proposed Regulations, however, an entity would be required to demonstrate that it serves a governmental purpose: The enabling legislation must demonstrate that the purpose for which the entity was formed is a public purpose, the entity must actually serve that purpose, and the entity must operate in a manner that provides a significant public benefit with no more than incidental private benefit.[18]

Governmental Control

The final criterion set forth in the Proposed Regulations, and the most controversial, is the requirement that a State or local unit or an electorate

---

[16] Section 1.103-1(b).

[17] Proposed section 1.103-1(c)(2).

[18] Proposed section 1.103-1(c)(3).

that is representative of the general public have an ongoing right or power to direct significant actions of the entity.[19] In clarifying the definition of control for this purpose, the Proposed Regulations provide that procedures designed to ensure the integrity of the entity but not to direct significant activities are insufficient to constitute control.[20] Therefore, the requirement to submit audited financial statements to a higher level governmental unit or to require open meetings does not satisfy the control requirement. On the other hand, the ongoing ability to approve and remove a majority of the entity's governing body, or to approve or direct the entity's significant uses of funds or assets in advance of that use may establish the requisite control.

The Proposed Regulations require control to be vested in either or both a State or local governmental unit or an electorate.[21]The governmental unit must possess a substantial amount of each sovereign power and act through its governing body or its elected or appointed officials acting in their official capacities.[22] The electorate must not constitute a "private faction" and must be established under State or local law of general application.[23]

A private faction is any electorate if the outcome of the exercise of control is determined solely by the votes of an unreasonably small number of private persons, which depends upon all relevant facts and circumstances. However, if any three private persons, in the aggregate,[24] constitute a majority of the votes necessary to determine the outcome, the electorate is *per se* a private faction.[25] On the other hand, if the smallest number of private persons who can combine votes to establish a majority is greater than 10 persons, the Proposed Regulations create a safe harbor that such electorate will not constitute a private faction.[26] Therefore, an electorate between four and nine persons does not fall within the safe harbor nor does it constitute a *per se* private faction. Relevant facts and circumstances to consider may include the entity's governmental purpose,

---

19 Proposed section 1.103-1(c)(4).

20 Proposed section 1.103-1(c)(4)(i).

21 Proposed section 1.103-1(c)(4)(ii).

22 Proposed section 1.103-1(c)(4)(i)(A).

23 Proposed section 1.103-1(c)(4)(i)(B).

24 Related parties, as defined in section 1.150-1(b), are treated as a single person. Proposed section 1.103-1(c)(4)(iii)(D)(1).

25 Proposed section 1.103-1(c)(4)(iii)(B).

26 Proposed section 1.103-1(c)(4)(iii)(C).

the number of members in the electorate, the relationships of the members of the electorate to one another, the manner of the apportionment of votes within the electorate, and the extent to which the members of the electorate adequately represent the interests of the persons reasonably affected by the entity's actions.[27]

Transition Rules[28]

If finalized as written, the rules contained in the Proposed Regulations generally would apply to all entities for all purposes of sections 103 and 141 through 150 beginning 90 days from the date of publication in the *Federal Register* (the "general applicability date").[29] However, the definition of political subdivision contained in the Proposed Regulations would not apply with respect to bonds issued before the general applicability date.[30] Similarly, the definition would not apply with respect to refunding bonds that are issued on or after the general applicability date to refund bonds issued prior to the general applicability date, provided that the weighted average of maturity of the refunding bonds is no longer than the remaining weighted average of the refunded bonds.[31]

Finally, entities that were created or organized before March 24, 2016, will have a three-year transition period before the Proposed Regulations definition of political subdivision applies to them. The preamble states that this period will provide existing entities an opportunity to restructure as necessary to satisfy the new definition while permitting them to continue to issue new bonds during the transition period.

Concluding Remarks

The current regulations under section 103 require a State or local governmental entity to possess sovereign powers in order to be treated as a political subdivision. The Proposed Regulations would expand this definition by also requiring that the entity operate for a governmental purpose and be governmentally controlled. The preamble acknowledges that the definition of "governmental control" in the Proposed Regulations

---

27 Proposed section 1.103-1(c)(4)(iii)(A).

28 Treasury and the IRS issued corrections to the transition rules in the Proposed Regulations on March 14, 2016. For clarity and brevity, this article discusses the rules as corrected.

29 Proposed section 1.103-1(d)(1).

30 Proposed section 1.103-1(d)(2).

31 Proposed section 1.103-1(d)(3).

"may present challenges" for entities such as community development districts of the type considered in the 2013 TAM:

> Some observers have suggested that, despite private control, development districts should be political subdivisions during an initial development period in which one or two private developers elect the district's governing body and no other governmental control exists. The Treasury Department and IRS recognize that the governmental control requirement may present challenges for such development districts. In these circumstances, the Treasury Department and IRS are concerned about the potential for excessive private control by individual developers, the attendant impact of excessive issuance of tax-exempt bonds, and inappropriate private benefits from this Federal subsidy.

The preamble then states that the Treasury Department and IRS seek 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, and what specific safeguards might be included in the recommended relief to protect against potential abuse. Given the widespread use of dirt bonds issued by community development districts to fund infrastructure projects,[32] it is not surprising that a significant number of comments on the Proposed Regulations were submitted before the 90-day submission period ended on May 23, 2016. Several criticisms of the Proposed Regulations are worth noting.

Proposed section 1.103-1(c)(3) requires in part that, in order to serve a governmental purpose, an entity must operate in a manner that provides a significant public benefit with no more than incidental private benefit. The Proposed Regulations do not provide guidance on how to determine whether a benefit is "significant" or "incidental" for purposes of this requirement. Because there is no guidance on the meaning of these critical terms, the governmental purpose requirement in the Proposed Regulations is not administrable and would lead to significant and protracted controversies between local governmental units and the IRS.

---

[32] *See, e.g.*, Briffault, "Who Rules at Home? One Person/One Vote and Local Governments," 60 *U. Chi. L. Rev.* 339, 359 (1993) ("…there are nearly 30,000 special districts in the United States, and the special district is our most rapidly growing form of local government.")

Next, in light of the fact that the Proposed Regulations are intended to apply for all purposes of sections 103 and 141 through 150, it is troublesome that the Proposed Regulations do not clarify whether or how the benefits provided to nongovernmental persons through the issuance of private activity bonds should be taken into account for purposes of proposed section 1.103-1(c)(3). Leaving aside the question of whether the issuer is a political subdivision, if an issue of bonds otherwise meets the requirements for treatment as a qualified private activity bond, is the private benefit from the bond issuance ignored or treated as per se incidental for purposes of proposed section 1.103-1(c)(3)? On the other hand, is the private benefit taken into account and treated as more than incidental if the bonds are *taxable* private activity bonds? The final version of proposed section 1.103-1(c) should clarify the interaction between the governmental purpose requirement and the regulations governing private activity bonds.

Although this point was not raised in any of the comments, it should be noted that the definition of "governmental control" in the Proposed Regulations might raise a question of constitutional law. Although the IRS was criticized for its position that the community development district under consideration in the 2013 TAM was not governmentally controlled because it was not "responsib[le] to a public electorate," it is true that in certain cases the U.S. Supreme Court has held that State and local governmental voting procedures that do not reflect the "one person, one vote" principle first enunciated in *Reynolds v. Sims*[33] violate the Equal Protection Clause of the Fourteenth Amendment. For example, in several cases plaintiffs successfully argued that the procedure for electing governing members of a local school district violated the Equal Protection Clause.[34] However, in other cases the Court held that the *Reynolds* principle did not necessarily apply to "a special-purpose unit of government assigned the performance of functions affecting definable groups of constituents more than other constituents."[35] The governance schemes for the special purpose (water reclamation or storage) districts in these cases allowed directors or board members to be elected by affected

---

[33] 377 U.S. 533 (1964).

[34] Hadley v. Junior College District, 397 U.S. 50 (1970); Kramer v. Union Free School District, 395 U.S. 621 (1969).

[35] Ball v. James, 451 U.S. 355 (1981); Salyer Land Co. v. Tulare Lake Basin Water Storage District, 410 U.S. 719 (1973); Associate Enterprises Inc. v. Toltec Watershed Improvement District, 410 U.S. 743 (1973).

landowners, with voting power proportionate to the amount of land owned, similar to the voting scheme governing the community development district considered in the 2013 TAM. Given that the definition of governmental control in the Proposed Regulations was motivated by the IRS's examination of the community development district in the 2013 TAM, it seems valid to ask whether the Proposed Regulations properly reflect the distinction made by the Supreme Court in these cases between local governmental units that do not need to adhere to the *Reynolds* principle and those that do.

Finally, because section 103 contains the only regulations defining the term "political subdivision," we need to question the extent to which the enhanced definition contained in the Proposed Regulations should apply to other areas of tax law not explicitly excluded. For example, an organization may exclude its income by reason of section 115 if it can demonstrate, in relevant part, that its income accrues to a political subdivision.[36] Similarly, section 170(c)(1), in relevant part, permits a charitable contribution deduction for contributions made to political subdivisions. The Proposed Regulations are silent on the extent, if any, to which the new meaning of "political subdivision" applies outside the context of the tax-exempt bond rules.

What's News in Tax **is a publication from the Washington National Tax practice of KPMG LLP ("KPMG") that contains thoughtful analysis of new developments and practical, relevant discussions of existing rules and recurring tax issues.**

[36] Section 115(1).

The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP..