THE BOND BUYER
Thursday, April 7, 2016 | as of
2:21 PM ET

Political Subdivision Politics

By Chas Cardall
April 7, 2016

Recently released proposed Treasury regulations seek to change the requirements for municipal bond issuers to qualify as issuers of tax-exempt bonds. Many lawyer and industry groups, as well as many States and local government agencies, will be commenting unfavorably on this proposal by the Internal Revenue Service. There are a number of areas in which the proposed regulations seem to make the wrong policy choice and create ambiguity instead of clarity, but that is not the focus of this article. Instead, this article focuses on the intellectual integrity of the proposed rules and the misuse of the rulemaking process.

"The term 'State or local bond' means an obligation of a State or political subdivision thereof." Being a "State or local bond" is the threshold requirement for tax exemption, and this language from Section 103 of the Internal Revenue Code and the underlying definition of the term political subdivision has existed for a very long time. Essentially, a political subdivision is a government agency with substantial taxing power, eminent domain power or police power. The proposed regulations attempt to redefine the meaning of the term political subdivision for purposes of the issuance of tax-exempt bonds.

The proposed regulations spring from the controversy surrounding an IRS challenge to the tax exempt status of bonds issued by certain community development districts in Florida and an associated IRS Technical Advice Memorandum 201334038. The Technical Advice Memorandum appeared to create new requirements for issuers to qualify as political subdivisions, and practitioners clamored for a repeal of the Memorandum or at least a rulemaking process that allows for comments and deeper consideration. The IRS chose the rulemaking process.

The Proposed Changes Impact the Tax Law Generally

The federal tax definition of political subdivision is important for a number of purposes independent of whether an entity is qualified to issue tax-exempt bonds (for example, whether the entity is subject to income tax or excise tax liability). The definition of political subdivision under Section 103 has been widely referenced as definitive for all federal tax purposes. Rather than coordinate with other parts of the IRS, the drafters of the proposed regulations would make dramatic changes to a long-standing definition and claim that those changes are intended only to impact tax-exempt bond qualification. But the changes could significantly impact other areas of the federal tax law. Are each of the other impacted areas of the federal tax law now required to adopt their own definition, to apply an old definition that no longer exists in the income tax regulations or to simply go along with this change?

Moreover, if the new rules really do apply only to the issuance of tax-exempt bonds, the proposed regulations package is significantly incomplete. A large number of issuers of tax-exempt bonds (possibly the majority) are not political subdivisions under existing law. Rather, these issuers are constituted authorities, integral parts of political subdivisions or other "on behalf of" issuers. The true impact of the proposed changes cannot be assessed unless the IRS also states its intention with respect to these other entities. If an entity with significant governmental powers is disqualified as a political subdivision due to more than incidental private benefit (one of the proposed new regulatory requirements), will a bond issuing agency of a State, city or county be disqualified if its bonds result in more than incidental private benefit? Perhaps such an authority would also qualify as an integral part entity, but the IRS has refused to provide any guidance, even informal guidance, on the integral part analysis, leaving the State and local government community in the dark.

The IRS Is Changing the Wrong Regulation

The new requirements are designed to thwart the abuse perceived by the IRS that certain tax-exempt, governmental purpose bonds are being issued for the impermissible benefit of private developers. The problem is that the proposed prohibition of non-incidental private benefit incorporates a private business use concept into a regulation relating to something entirely different - the authority to issue bonds. This is effectively changing the private business use rules (which exist under Section 141 of the Internal Revenue Code) through a new requirement under Section 103. This is a deeply flawed and troubling approach. The private business use rules are well-developed and intricate. If there is a legitimate concern about non-incidental private benefit, that concern should be dealt with in a rulemaking project under Section 141, so that the appropriate context and impact on other rules is apparent.

This is a bigger point than the mere placement of a new rule in the income tax regulations. To date, the regulatory requirements for an issuer to qualify to issue tax-exempt bonds has focused on the governmental powers held by the issuer because the related language in the Internal Revenue Code focuses on the attributes of the issuer, not on the attributes of the particular bonds or the project being financed. By comparison, the concepts relating to private business use have focused on the project being financed and the other attributes of individual bond issues because that is the focus of the related language in the Internal Revenue Code. If this distinction between issuer attributes and project/bond issue attributes is not maintained, the resulting requirements will conflict. For example, in at least some circumstances the proposed regulations would make the private security or payment test of Section 141 irrelevant. The point here is not to argue against an incidental private benefit prohibition. The point is that any such prohibition needs to be vetted as a change to the rules under Section 141 and not Section 103.

In fact, this new requirement is similar in many respects to heavily criticized and subsequently withdrawn general prohibitions relating to "economic benefit" and to the "discharge of a primary legal obligation" originally set forth in 1994 proposed regulations under Section 141. There were many negative comments on those proposed regulations. The comments focused on whether the mere existence of private economic benefit was enough to result in private business use and whether traditional assessment bond financing of government mandated infrastructure should be prohibited. In the end, the IRS correctly determined to focus on the use of the assets financed and not to take away from States and local government agencies one of their most powerful and consistently used infrastructure financing mechanisms.

Assuming that there in fact is a problem to fix, this proposal by the IRS to change the political subdivision definition is not an acceptable approach. At best, it raises significant questions about which entities qualify as political subdivisions for general tax purposes. Worse, it creates a new private business use limitation that is not consistent with the Internal Revenue Code or the existing regulatory framework. Thus, this new limitation creates significant uncertainty, because it exists outside the context of similar, well-developed rules. In municipal finance, where investors demand unqualified legal opinions, creating uncertainty is bad policy.

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