

IRS Proposes New Definition of “Political Subdivision” for Tax-Exempt Bond Purposes

Introduction

On February 23, 2016, the Internal Revenue Service (“IRS”) published proposed rules to amend 26 C.F.R. Part 1 to revise the definition of “political subdivision” for tax-exempt bond purposes (“Proposed Rule”).¹ The purpose of this rulemaking is to confirm the types of entities authorized to issue tax exempt municipal bonds.

Summary of Proposed Rule

The Proposed Rule revises the definition to now include two new factors to be deemed a political subdivision. In addition to the traditional requirement that a political subdivision exercise sovereign power, the Proposed Rule requires an issuer of tax-exempt bonds to now also show governmental purpose and governmental control. Thus, to be a political subdivision, the entity must meet all three of the following requirements: (1) exercise sovereign power, (2) have a governmental purpose, and (3) be under governmental control.

Sovereign Powers

The Proposed Rule maintains the longstanding requirement that a political subdivision be empowered to exercise at least one of the generally recognized sovereign powers: eminent domain, police power, and taxing power.

Governmental Purpose

Codifying common practice in case law and the administrative process, the Proposed Rule now requires consideration of whether the entity serves a public purpose. This purpose must exist at the time the entity is created, which is generally evidenced in the entity’s enabling legislation, and must continue throughout the entity’s existence. Although a private benefit can also exist, that benefit must only be incidental to the public purpose served.

Governmental Control

Governmental control depends on the nature of the control over the actions of the entity and who possesses such control. The control must be ongoing and enable the holder to direct significant actions of the entity. Three touchstones of control are provided in the Proposed Rule: (1) a governmental entity controls both the appointment and removal of a majority of the subordinate entity’s board; (2) a majority of the governing body of the entity is elected at large, so long as elections are periodic and of reasonable frequency; or (3) a governmental entity’s ability to significantly control or direct the use of the subordinate entity’s use of funds.

¹ *8Definition of a Political Subdivision* 81 Fed. Reg. 8870 (Feb. 23, 2016) (to be codified at 26 C.F.R. Part 1).

Correspondingly, control must be vested in a state or local governmental unit or a qualified electorate rather than in private individuals, business corporations, trusts, partnerships, or other entities generally unassociated with the government. As such, if an unreasonably small faction of private persons controls an electorate, that electorate's control does not constitute governmental control. To make such a determination, the Proposed Rule contains a quantitative range of acceptable and unacceptable concentrations in voting power: an electorate is per se qualified as governmental control if more than ten (10) members are needed to reach majority and is per se disqualified as governmental control if three (3) or less voters constitute a majority. For purposes of calculating voting power, related parties are treated as a single voter and the votes of the related parties are aggregated.

Applicability and Rule Transition Period

The Proposed Rule provides that the new 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 of three years and ninety days from the date the Proposed Rule is finalized to allow entities time to restructure as necessary to satisfy the new definition of political subdivision.

Effect on Water Districts (including Special Districts and Authorities)

The proposed rule change that may have the most impact to Article XVI, Section 59 water conservation and reclamation districts is the addition of the governmental control factor. This new rule provision has the potential to impact district creations where the electorate is small. Moreover, the new governmental control factors would have to be met in addition to the governmental purpose requirements mandated by state law. In addition, entities with appointed boards will need to examine the Proposed Rule provisions regarding the method of board appointment and removal. One of the foreseeable unintended consequence of the reclassification as a private entity is that such organizations may be precluded from state clean water revolving loan programs.

Path Forward

The IRS requested public comments in writing on or before May 23, 2016. A public hearing was held June 6, 2016. The IRS has not indicated when a final rule is expected. [Click here](#) to view a copy of the draft rule.

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