

Chapman Client Alert

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Current Issues Relevant to Our Clients

Proposed Regulations Concerning Political Subdivisions

The Internal Revenue Service (the “IRS”) recently released proposed regulations (the “Proposed Regulations”) concerning the definition of a “political subdivision” for purposes of tax-exempt financing. The Proposed Regulations are not yet effective and are subject to further changes by the IRS. The Proposed Regulations, if adopted in their current form, would provide new requirements for an entity to qualify as a political subdivision for purposes of tax-exempt financing.

In general, an obligation must be issued by (or on behalf of) a state, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof in order for the interest on such obligation to be exempt from federal income taxation. The Proposed Regulations were written, in part, to address IRS concerns regarding certain community development districts that the IRS did not consider to be political subdivisions. In general, the IRS was concerned that certain community development districts should not be political subdivisions because the IRS believed such districts did not have a governmental purpose and were not governmentally controlled. Accordingly, the Proposed Regulations, as more fully discussed below, require an entity to have a “governmental purpose” and to be subject to “governmental control” in order to qualify as a political subdivision.

Proposed Regulations

Under the Proposed Regulations, an entity would qualify as a political subdivision, and could therefore issue tax-exempt obligations and not constitute a private user of bond financed facilities, if such entity meets three requirements. The entity must: (i) exercise a substantial amount of at least one sovereign power; (ii) have been formed for a governmental purpose and continue to serve such governmental purpose; and (iii) be governmentally controlled.

An entity will meet the first requirement if it exercises a substantial amount of at least one of three sovereign powers. Such sovereign powers consist of eminent domain, police power, and taxing power. This requirement is essentially unchanged from current law.

An entity will meet the second requirement, as set forth above, if the entity serves a governmental purpose. A governmental purpose requires, among other things, that the purpose for which the entity was created, as set forth in its enabling legislation, be a public purpose and that the entity actually carries out that purpose. The Proposed Regulations also require that the entity operate in a manner that provides a significant public benefit with no more than incidental private benefit.

An entity will meet the third requirement, as set forth above, if it is governmentally controlled. The Proposed Regulations provide detailed rules for determining what constitutes governmental control and which parties must possess that control.

The Proposed Regulations define control to mean ongoing rights or powers to direct significant actions of the entity. Rights or powers to direct the entity’s actions only at a particular point in time are not ongoing and, therefore, do not constitute control.

The Proposed Regulations provide three non-exclusive types of rights or powers that may constitute control: (i) the right or power both to approve and remove a majority of an entity’s governing body; (ii) the right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency; or (iii) the right or power to approve or direct the significant uses of funds or assets of the entity in advance of that use.

Control of an entity must be vested in: (i) a general purpose state or local governmental unit that has a substantial amount of each of the sovereign powers discussed above and is acting through its governing body or through duly authorized elected or appointed officials in their official capacities; or (ii) in an electorate established under an applicable state or

local law of general application. However, an electorate's control of an entity does not constitute governmental control of the entity if a small faction of private persons controls the outcome of the exercise of control. The Proposed Regulations provide that an entity controlled by an electorate is not governmentally controlled when the outcome of the exercise of control is determined solely by the votes of an unreasonably small number of private persons, depending on all facts and circumstances. The number of private persons controlling an electorate is always unreasonably small if the combined votes of three private persons possess, in the aggregate, a majority of the votes necessary to determine the outcome of the relevant exercise of control. The number of private persons controlling an electorate is not unreasonably small if the smallest number of private persons who can combine votes to establish a majority of votes necessary to determine the outcome of the relevant exercise of control is greater than ten persons. In other cases, the facts and circumstances test must be used to determine whether a small faction controls an outcome. For purposes of these tests, related parties are treated as a single person.

Effective Dates

Although an issuer may elect to apply the definition of political subdivision in the Proposed Regulations, in whole, but not in part, to current transactions, subject to certain transition rules, the Proposed Regulations generally will apply on a date beginning 90 days after the Proposed Regulations are finalized. The definition of political subdivision does not generally apply to an entity with respect to bonds issued before the general applicability date in the prior sentence and does not generally apply to refunding bonds (issued to refund bonds to which such final regulations would not apply) after the general applicability date if the weighted average maturity of such refunding bonds is not longer than the remaining weighted average maturity of the refunded bonds.

For More Information

If you would like further information concerning the matters discussed in this article, please contact a member of our Public Finance Group or visit us online at chapman.com.

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