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## IRS issues memorandum on public infrastructure financing

On May 9, the national office of the Internal Revenue Service issued a Technical Advice Memorandum finding that a certain community development district in Florida was not a “political subdivision” within the meaning of Section 1.103-1(b) of the Income Tax Regulations. The TAM was generally made available to the public on June 4. Whether a community development district, which is facially similar to a Title 32 special district in Colorado, is a political subdivision under the IRS’s new interpretation of Section 1.103-1(b) has significant ramifications, because interest on bonds sold by an issuer that is a “political subdivision” may qualify under Section 103(a) of the Income Tax Regulations for an exemption from tax liability for federal income tax purposes.

The subject community development district was organized under Florida law by a developer of a retirement community to provide public infrastructure and other public amenities to serve the community. The district appears to function in much the same way, and is subject to similar state regulation, as Title 32 special districts in Colorado. Further, the district was organized and operated in a manner that provided for continued long-term control of the board of directors of the district by the developer, again similar to Title 32 special districts serving commercial developments or so-called “control districts” serving mixed-use developments.

Section 1.103-1(b) defines “political subdivision” as “any division of any state or local government unit which is a municipal corporation or which



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accountable, directly or indirectly, to a general electorate” and that the democratic process helps “to ensure that subsidized bond financing is used for projects which the general electorate considers appropriate state or local government purposes. A process that allows a private entity to determine how the bond subsidy should be used without appropriate government safeguards cannot satisfy §103.”

Central to the IRS’s determination that the Florida district was not a political subdivision was that the district was “organized and operated in a manner intended to perpetuate private control, and to avoid indefinitely responsibility to a public electorate ...” Although the board of directors of the district was elected by a majority of the landowners within the boundaries of the district, the developer and its affiliates owned a substantial majority of such land and therefore effectively controlled the district and its board of directors.

Title 32 special districts in Colorado are often organized in a manner that provides for long-

has been delegated the right to exercise part of the sovereign power of the unit.” In considering what entities satisfy this “political subdivision” test, the IRS opined that a “governmental unit is inherently



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term developer control of the district through election of its board, either because the property within the boundaries of the district is owned in fee by the developer and leased to retail and commercial users or because the boundaries of the district are limited to ensure that only the developer owns property within such boundaries (i.e., a “control district”). Because the TAM, in determining the Florida district did not qualify as a political subdivision, focused on whether a sufficient number of nondeveloper-related landowners existed within the boundaries of the district for purposes of electing its governing board, the long-standing method of financing public improvements in Colorado by issuance of tax-exempt bonds by Title 32 special districts generally controlled by the developer may be impacted.

The TAM only interprets federal tax law and should not affect the state of Colorado’s interpretation of “political subdivision,” including with respect to a Title 32 special district’s issuance of bonds that are tax-exempt at the state level (for state income tax purposes). Accordingly, a control district may issue bonds that are taxable at the federal level but tax-exempt at the state level.

Developers contemplating using a Title 32 special district

to issue tax-exempt bonds for federal income tax purposes to finance public infrastructure should take into account the effect of the TAM as it relates to the developer’s control of the issuing district and a lack of third-party landowners having voting rights with respect to such district. Developers should evaluate whether the project’s financing needs require issuance of double tax-exempt bonds, or whether bonds that are taxable or are tax-exempt at the state level only are feasible options. The advantages of a control district issuer should be weighed against the effect of increased interest rates on bond sizing and other factors.

If the issuance of bonds that are tax-exempt at both the federal and state levels is necessary for the financial viability of the project, the TAM may preclude using a control district as the issuer until the ramifications of the TAM are more fully understood. Instead, a Title 32 special district that the developer may not control beyond initial sales of property to unrelated third parties may need to be considered as the issuer. Because the developer may lose control of the issuing district, unintended control-related consequences of such financings should be considered and addressed.

The TAM does not address the potential impact on owners (purchasers) of tax-exempt bonds (at the federal level) previously issued by control districts.

This article is intended to be generally informative about a complex area of tax law; however, nothing in this article should be construed as providing tax advice with respect to any particular transaction or matter.▲