

# Tax Tip

*By Charles H. Egerton and Christine L. Weingart*

## New TAM May Curtail Ability of Community Development Districts to Issue Tax-Exempt Bonds

On May 9, 2013, a Technical Advice Memorandum<sup>1</sup> (the “TAM”) was issued with respect to a community development district (“CDD”) in Florida. Although the CDD and the developer that was instrumental in its formation were not identified in the TAM, it is widely known that it was a community development district created under Florida law by the developer of a very large retirement community in the Central Florida area known as “The Villages.”<sup>2</sup> The TAM challenges the tax-exempt status of bonds issued by the CDD by taking the position that the CDD was not a “political subdivision,” as such term is used in Code Sec. 103(c). The TAM has raised major concerns regarding the status of CDDs in Florida, where approximately 600 CDDs currently exist. A number of other states have similar statutes, and any special districts formed thereunder would presumably also be vulnerable to challenge under the analysis set forth in the TAM.

### Background on CDDs in Florida

Florida’s laws regarding CDDs are set forth in Chapter 190 of the Florida Statutes, entitled the Uniform Community Development District Act of 1980 (the “Act”).<sup>3</sup> The purpose of the Act was to authorize a uniform procedure by general law to establish an independent special district as an alternative method for management and financing of basic services for community development and to provide by general law for the uniform operation, exercise of power and procedures for termination of such districts.<sup>4</sup> The Act provides detailed rules for establishing CDDs, as well as the creation, election, powers and duties of the CDD’s



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board of supervisors.<sup>5</sup> Under the Act, the CDD has (and its board may exercise) certain powers, including specified powers related to public improvements and community facilities.<sup>6</sup> The CDD has limited powers of eminent domain, with respect only to uses relating to water, sewer, district roads and water management.<sup>7</sup> In addition, the CDD may issue bonds and bond anticipation notes, and may levy, assess and enforce the collection of *ad valorem* and other taxes, as well as certain special assessments.<sup>8</sup> The Florida Statutes specifically define a CDD as a “local unit of special-purpose government”.<sup>9</sup> The CDD is under the supervision of the state, subject to certain statutory limits on its behavior as an entity of the state.

The board of a CDD is initially elected by the landowners, based on acreage within the geographic boundaries of the CDD owned by them, with a majority of votes controlling.<sup>10</sup> Generally, this means that the developers who petition to establish a CDD and who at the outset are the majority landowners initially control the board. However, in the case of a CDD which contains residential or mixed-use properties, after a certain number of years, once a CDD reaches a certain number of qualified electors (residents within the district eligible to vote), the election of the board transitions to the qualified electors at a general election.<sup>11</sup> If the properties contained within the CDD consist solely of nonresidential properties, there generally are no “residents” and the Florida statute provides that the land owners will continue to elect the members of the board. The CDD addressed in the TAM falls within this latter category.

## **Tax-Exempt Bonds and CDDs**

Code Sec. 103(a) provides that gross income does not include interest on any state or local bond. A “state or local bond” means an obligation of a state or political subdivision thereof.<sup>12</sup> The term “political subdivision” is defined in the regulations as “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 that unit.”<sup>13</sup>

The TAM concluded that the CDD at issue was not a political subdivision as defined in the regula-

tions because it was not a division of a state or local government. Essentially, the TAM concluded that the CDD was not a division of a state or local government because it was initially organized and operated in such a “manner that insured continued effective control” of the board by the developer, rather than a general electorate or an existing governmental body. The TAM asserts that Code Sec. 103 “relies, in large part, on the democratic process to ensure that subsidized bond financing is used for projects which the general electorate considers appropriate State or local government purposes.”

The TAM cites no authority for its conclusion that an entity must be “responsib[le] to a public electorate, either directly or through another elected State or local government body” in order to qualify as a political subdivision. Indeed, outside of the Code and regulations, which provide exactly as quoted earlier, the only authority cited by the TAM is two revenue rulings.

Revenue Ruling 78-276 deals with exemptions for toll authorities.<sup>14</sup> This ruling is cited frequently (including in the TAM) for its statement that the “term ‘political subdivision’ has been defined consistently for all federal tax purposes as denoting either a division of a state or local government that is a municipal corporation or a division of such state or local government that has been delegated the right to exercise sovereign power.” The TAM cites this ruling for its conclusion that the CDD cannot qualify as a political subdivision “whether or not it is a municipal corporation . . . or has the right to exercise sovereign powers . . . unless it also can demonstrate that it is a division of a state or local government.” In other words, the TAM cites this ruling in support of its conclusion that the definition of political subdivision is a two-pronged test, requiring the entity to (1) be a municipal corporation or a division of a state or local government, *and* (2) be the recipient of a delegation of the right to exercise sovereign powers. However, Rev. Rul. 78-276 never addresses the question of whether the entity at issue in the ruling was a division of a state or local government, instead analyzing only the issue of whether the entity had been delegated sovereign powers.

Revenue Ruling 83-131 addresses the issue of whether certain excise tax exemptions provided for

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state and local governments are also available to electric and telephone member corporations.<sup>15</sup> The ruling concludes that the corporations do not qualify as political subdivisions, in part, because the corporations were “not controlled directly or indirectly by a state or local government” but rather by a board of directors “independent of such authority.” The TAM cites this ruling as indirect support for its conclusion that an 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. However, the ruling does not cite any authority for its position, and goes on to analyze in great detail the issue of delegation of sovereign powers.

The vast majority of authorities dealing with the issue of whether an entity qualifies as a political subdivision focus solely on the delegation of sovereign powers.<sup>16</sup> For instance, Revenue Ruling 77-143 holds that a port authority is a political subdivision because it was created to lease, erect, construct, make, equip and maintain port facilities and because it can fix rates and condemn property.<sup>17</sup> If the definition of “political subdivision” is truly meant to be a two-pronged test as set forth in in the TAM, then it is curious that only the TAM has ever treated it as such.

Of particular interest in considering the TAM is that this is not the first time the IRS has considered the issue of CDDs. In 1977, the IRS issued General Counsel Memorandum 36944, which also addressed the applicability of Code Sec. 103 to bonds issued by a CDD.<sup>18</sup> The CDD at issue in the GCM appears substantially similar to that at issue in the TAM, except that the CDD was not able to unilaterally exercise eminent domain powers under the version of the Florida CDD statute that was applicable at that time, but rather had to rely upon the county government’s eminent domain power. That is, the CDD could enter into agreements with the county whereby the county would at its discretion exercise eminent domain power to acquire property for use by the CDD. Because of this factor, the GCM concluded that the CDD did not have sufficient delegation of sovereign powers.

The GCM goes into a detailed discussion of the development of the definition of “political subdivision” including a cite to an opinion of the attorney general which provided that the term is “broad and comprehensive and denotes any division of the State made by the proper authorities thereof,” going on to focus on the delegation of powers which have always

been regarded as public.<sup>19</sup> Based on this language, it can certainly be strongly argued that the issue of whether or not an entity is a division of a state is really subsumed into the second part of the definition—whether the entity has been delegated sovereign powers. The GCM held that the CDD at issue had not been delegated sovereign powers because it did not have the power of eminent domain. It did not address the issue of whether the CDD was subject to the general electorate at all. The CDD at issue in the TAM had limited eminent domain powers as well as the power to assess and collect *ad valorem* taxes, but this is never analyzed by the IRS in the TAM because the issue was decided solely on the “division” aspect.

The TAM illustrates that the IRS is concerned with CDDs where the board is perpetually under private (developer) control. The fact that the Florida Statutes define a CDD as a local unit of special-purpose government, and subjects the CDD to oversight by the state as well as holding the CDD to standards also required of local government, is not given any weight.

## Conclusion

Although clearly the existence of the TAM is reason for concern for CDDs that are structured similarly to that in the TAM (that is, that will never be subject to a general electorate), the analysis in the TAM is not strong, and is certainly open to question.

Although we argue in this article against the solidity of the conclusions made by the IRS in the TAM, it is important to be aware of even broader implications should the TAM’s holdings be upheld. The term “political subdivision” is also used in Code Sec. 115, which generally provides tax-exempt status for federal and state governments or any political subdivision thereof. Therefore, if a CDD is not a political subdivision for Code Sec. 103 purposes, it is likely not a political subdivision for Code Sec. 115 purposes, and unless tax exemption is available and has been applied for under Code Sec. 501, then the income of the CDD (including any fees collected from assessments) would be taxable as well. This TAM, if upheld, could have far-reaching consequences for many CDDs.

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## ENDNOTES

<sup>1</sup> TAM-127670-12.

<sup>2</sup> See, e.g., Jason Garcia, *As IRS cracks down on The Villages, Disney World watches*, ORLANDO SENTINEL, July 13, 2013.

- <sup>3</sup> Fla. Stat. § 190.001 et seq.  
<sup>4</sup> Fla. Stat. § 190.002(3).  
<sup>5</sup> Fla. Stat. §§ 190.006 and 190.007.  
<sup>6</sup> Fla. Stat. § 190.012.  
<sup>7</sup> Fla. Stat. § 190.011(11).  
<sup>8</sup> Fla. Stat. §§ 190.021 and 190.022.  
<sup>9</sup> Fla. Stat. § 190.003(6).  
<sup>10</sup> Fla. Stat. § 190.006.  
<sup>11</sup> Fla. Stat. § 190.006(2).  
<sup>12</sup> Code Sec. 103(c).  
<sup>13</sup> Reg. § 1.103-1(b).  
<sup>14</sup> Rev. Rul. 78-276, 1978-2 CB 256.  
<sup>15</sup> Rev. Rul. 83-131, 1983-2 CB 184.  
<sup>16</sup> See e.g., *A.J. Shamberg Est.*, CA-2, 44-2 USTC ¶9446, 144 F2d 998; C.  
*White Est.*, CA-2, 44-2 USTC ¶9447, 144 F2d 1019.  
<sup>17</sup> Rev. Rul. 77-143, 1977-1 CB 340.  
<sup>18</sup> GCM 36994, February 3, 1977.  
<sup>19</sup> 30 O.A.G. 252, 253 (1914).



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