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Internal Revenue Service Proposed Rule Addressing Tax-Exempt Bonds: Private Water Law Blog Notes Potential Impact on Irrigation Districts

Arkansas Environmental, Energy, and Water Law Blog

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The blog *Private Water Law* has a March 17th post noting that a rule proposed by the Internal Revenue Service (“IRS”) related to tax-exempt bonds could “potentially affect”:

... irrigation or similar districts that supply water to a relatively small number of landowners, by excluding such districts from the definition of a “political subdivision”.

The IRS issued a Notice of Proposed Rulemaking in the Federal Register on February 23rd for the purpose of providing guidance regarding the definition of “political subdivision” for purposes of tax-exempt bonds. See 81 Fed. Reg. 8870. The regulations are deemed necessary to specify the elements of a “political subdivision”.

The proposed rule would affect state and local governments issuing tax-exempt bonds and users of property financed with tax-exempt bonds.

To qualify as a political subdivision under the proposed rule, an entity must meet three requirements, taking into account all the facts and circumstances:

- Sovereign Powers
- Governmental Purpose
- Governmental Control

The *Private Water Law* blog notes in regards to the two new qualifications (i.e., that the entity issuing bonds have a governmental purpose and be governmentally controlled):

Governmental purpose is determined by the purpose for which the entity was created, as set out in its enabling legislation, and the actual conduct of the entity [§ 1.103-1(c)(3)]. Supplying of water for irrigation and other purposes has been widely recognized as a public purpose, and irrigation districts are almost certain to satisfy the governmental purpose requirement under normal circumstances. In fact, the rule includes special districts that provide water, sewer, reclamation or irrigation services as examples of political subdivisions [§ 1.103-1(c)(1)].

The blog notes, however, that there are potential difficulties for what it characterized as “relatively small irrigation districts”. It cites potential problems arising from the requirement of government control [§ 1.103-1(c)(4)] stating:

Under the proposed rule this requirement is met if the issuing entity is controlled by a state or local governmental unit or an electorate. Control is defined as the power to direct significant actions of the entity and may be determined by three non-exclusive factors: (1) the power to approve or remove a majority of the governing body; (2) the power to elect a majority of the governing body; and (3) the power to approve or direct the significant uses of funds or assets of the entity in advance. While irrigation districts are generally controlled by electors who own lands within the district, pursuant to normal state election laws, the proposed rule specifically excludes an electorate consisting of a “private faction” [§ 1.103-1(c)(4)(ii)(B)]. A private faction exists if control of the entity is exercised by the votes of an unreasonably small number of private persons. The rule expressly states that a controlling group of voters will always be unreasonably small if it contains three or fewer persons and will never constitute a private faction if it contains more than 10 persons. Groups of between four and 10 persons will be evaluated on the basis of all facts and circumstances. For purposes of counting voters, related parties are treated as a single person. This rule excluding private factions has the potential to impact smaller irrigation districts. Determining the number of voters in an irrigation district and their degree of control would require a fact-specific analysis. However, there very likely exist small irrigation districts in the western United States that are controlled by a “private faction” as defined in the IRS rule, and therefore would lose the ability to issue tax-exempt bonds. Smaller irrigation districts may include lands owned by a limited number of farmers, especially after application of the “related parties” rule. Compiling the votes of the largest landowners within a district may well result in control of the district by 10 or fewer persons, and the proposed rule should be concerning to those districts and their landowners.

Click here to download a copy of the proposed IRS rule and a link to the blog post can be found here:

[http://privatewaterlaw.com/2016/03/17/irrigation-districts-and-the-irs-proposed-rulemaking-for-tax-exempt-bonds/.](http://privatewaterlaw.com/2016/03/17/irrigation-districts-and-the-irs-proposed-rulemaking-for-tax-exempt-bonds/)