The Consequences of Tax Exempt Debt for Private Real Estate Development: The Case of The Villages

BY OWEN M. BEITSCH, PH.D., CRE

INTRODUCTION

Several states, especially those where large master-planned communities are common, have legislation permitting the sale of tax exempt debt to support infrastructure development. Typically, the debt is issued by a special district that exercises many of the powers of a local government. While the particular legal structure may vary across the states, these special districts are often instrumentalities tied to a private real estate developer able to take advantage of the resources made available through bond financing.

California and other states have many of these special districts, but their use in Florida has been especially remarkable. In the case of Florida, where several hundred community development districts (CDD) now exist, the shared interests or actions of the developer and the district acting as a government unit are explicitly authorized. Florida's enabling legislation openly encourages use of these districts as cost-effective vehicles to provide needed public services for major projects. At the same time, the legislation envisions communities funded or financed in such a fashion would, over a prescribed time frame, shift from the developer's control to that of the project's residents.

Almost any public facility can be financed with the tools made available through these types of districts, including but not limited to roads, utilities, schools, recreational facilities, and even some off-site improvements. The common form of financing involves varying assessments levied against the underlying land as the primary means of payment for any bond debt.

About the Author

Owen M. Beitsch, Ph.D.,CRE, *is a senior principal with Real Estate Research Consultants Inc. (RERC), an advisory services firm in Orlando, Florida, and affiliated with GAI. Beitsch also is a faculty member at the University of Central Florida where he teaches land use regulation and real estate economic in the school's urban planning program. He currently serves as associate editor of* Real Estate Issues.

Until the residential market slipped into chaos, the market for the debt of these communities was very active, and some of the country's most recognized real estate projects are special districts. The combination of well-capitalized projects, favored tax treatment, rapidly rising land values, and a continued stream of assessments typically on parity with local property taxes made the securities of these districts especially attractive to large classes of investors. To date, Florida's CDDs have, by themselves, issued almost $7 billion of tax exempt bonds for a variety of purposes.

Much of the activity enabled by these special districts will continue to set the quality standard for real estate development. The implemented projects tend to be large, rich in amenities, and favored by the residents over other kinds of communities. Where several projects fell short of

market expectations in the recession, they still delivered significant infrastructure capacity that will support future development.

By most accounts, The Villages, north of Orlando, is one of Florida's most successful special district communities. Since the beginning, several hundred homes have been constructed and sold *annually* in the project. Centered on active retirement housing, The Villages is bringing unfavorable attention to its tax exempt activity and, by extension, to every bond issue directed toward the capitalization of certain facilities or real estate activities.

Once broadly accepted, these kinds of ventures now face further scrutiny. At the very least, this closer look will add unwelcome complexity to real estate financing matters, and it may widen the basis for litigation already being filed.

THE RULING

For some time, The Villages had been operating certain large recreational activities that are an important centerpiece of this and other large real estate projects. In May 2013, the Internal Revenue Service (IRS) reported debt associated with these facilities or activities may not be tax exempt because, when issued, the project or the specific entity that had been the sponsor of the debt was not actually a political subdivision of the state.[1] The ruling appears to say the specific Villages legal entity involved was not a public body or instrumentality and may not be entitled to take advantage of the powers often associated with the typical special district structure.

> *We believe 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.* [2]

As one can observe from the proliferation of such projects in Florida especially, it has not been uncommon for other special districts using tax exempt debt to engage in at least similar initiatives, constructing and managing the large facilities expected in every major real estate development.

If the party concerned was not a qualified issuer of tax exempt bonds, an obvious interpretation of the IRS Technical Advice Memorandum is that any interest paid on bonds issued would become fully taxable income to those owning the bonds. Those bondholders would subsequently owe income taxes on the interest income that had been received, possibly penalties and interest as well.

Apparently, more than $400 million worth of tax exempt debt is linked to various recreational and utility facilities managed or constructed in this major community. Also obvious, those bondholders adversely affected by receiving unexpected taxable income will seek financial relief. Toward that end, they would likely look to the specific entity of The Villages involved as well as any related parties to defray the costs of additional taxation. As part of their effort to seek redress, bondholders or their agents also could act against residents in The Villages who pay various fees or charges to utilize the facilities in question. Even with a negotiated settlement, the expense realized would be enormous. The consequences, however, may reach well beyond this setting and any immediate costs or damages.

The specific actions or intent of The Villages notwithstanding, Florida's legislature inadvertently invited the project's problems when it intentionally blurred the line between the functions of government and private actors. Whatever similarities the legislature envisioned, the IRS is strongly arguing that government and private business have fundamentally different purposes and objectives.

As noted, Florida's community development districts, and a number of similarly created special districts elsewhere, are governed by appointed boards. Without regard to the nature of the larger project in terms of its residential or non-residential orientation, Florida's legislation very clearly allows the developer to name personal appointees to serve on these boards as they are initially created. But Florida law also prescribes governance will eventually pass to residents in the guise of their own duly elected board members. The change occurs once the concentration of residents and units has exceeded certain thresholds.

In those cases where a special district is comprised exclusively of commercial development, it has in effect few if any residents. Under those circumstances, landowners would continue to appoint the members to the regulating board. The Villages appears to have run afoul of the responsibility to distinguish commercial and residential functions that ultimately speak to the proper means of control.

The IRS memorandum focuses principally on the way The Villages acted to cede organizational power to others with the passage of time or a modification in the mix of activity. Or rather the way it *failed* to act. More specifically, the IRS claims the developer and The Villages performed in such a way that control of its own interests *would never* be diluted and worked to forestall a broader election of

any non-aligned board members virtually forever. Indeed, despite the sale of more than 40,000 homes over two decades, the particular controlling entity in question had yet to transition to residents.

> *[Florida's legislation] contemplated that a board would be elected by the Qualified Electorate when a district acquired a sufficient number of residents. Even after over 20 years, this has not happened in the Issuer's case. Indeed, the facts indicate that Issuer was intentionally structured to ensure that this never could happen.*[3]

Among the observations made by the IRS, the developer structured the entity involved in the matter to avoid control by any persons other than its selected representatives or associates. As well, persons connected with The Villages used their position to induce Lady Lake—the superior local government in the region with comprehensive regulatory authority over district practices—to amend the boundaries of the special district in such a way that diminished or removed opportunities for future residential construction. The change in boundaries consequently also prohibited the occasion for future residents to engage in governmental activities.

> *… the Issuer was organized and operated in manner that insured continued effective control of the Board by A, rather than a general electorate or an existing governmental body. The Board was selected by majority vote of landowners, and, at all times, A was in a position, through entities under his control, to select all members of the Board…. The result was that during the relevant years, the Board was composed of individuals who, in all but one limited case, consisted of A, members of his family, directors, officers, or employees of the Developer, and the chief executive officer of Bank owned and controlled by A and his family.*[4]

Assuming such a negatively purposeful strategy, it would become almost impossible for residents to control board policies and practices at any point in time.

Perhaps it is a small comfort that the IRS does not systematically look to findings outlined in its memoranda as precedent to future rulings or actions. Even so, rational planning would suggest a need to embrace the agency's comments as basic principles when a special district underwrites what is primarily a real estate development program engaged in activities or programs that may be viewed as substantively *non-residential* in scope or emphasis. The IRS position could be construed as an admonishment to boards to oversee their existing non-residential projects or initiatives with discretion and to display greater care in the performance of their duties. Given the temporal dimension of The Villages case, strict behavioral standards become more critical over an extended period when there are questions about, or logical expectations of, change in policy or administrative practice.

> *Board members are subject to general laws relating to public officers and employees, including ethical standards requiring that public officials be independent and impartial, and that public office not be used for private gain other than the remuneration provided by law. Public officials must discharge their duties in the public interest and must act as agents of the people in holding their positions for the benefit of the public.*[5]

At the very same time, the seemingly non-residential focus of the IRS memorandum offers subtle implications for special districts largely of a *residential* character or focus. Like many rulings or judgments of this type, they can be instructive about things left *unsaid*.

By centering on the locus of control and the procedures to assure richer public engagement, the IRS tacitly appears to approve the predominantly residential special district where future control by residents on site seems a procedural certainty. The distinction between commercial and residential special districts (or the functions and components occurring therein) seems illusory, however, remembering that The Villages is itself substantively a residential community, and many of the criticized expenditures involve features broadly supportive of the residential objective. Fundamentally, these features were incorporated in the larger development precisely for that purpose.

OTHER IMPLICATIONS

How then to draw a distinction between residential initiatives and activities otherwise deemed primarily non-residential in scope or function? The obvious response leads to the self-evident strategy which discretely parses or isolates any suspect non-residential activities and related expenditures to avoid IRS curiosity in the first place. But disassembling tax exempt bond financing *already in place* is a substantially complex adventure and, to the extent there is a challenge, delinquent actions may mitigate, without undoing, the damage that already occurred. So, it is only practical to explore the separation of each activity

at the initial stages of planning and financing, *before* debt is issued. Consequently, many *now-operating* special districts, generally considered residential in focus and form, may be exposed on several grounds. Because of the size of these residential projects, it is not unusual to see circumstances, markets and programs change, or to find residents demanding more services, many of which could be construed as essentially private. The level of required "publicness" intimated in the IRS memorandum may be only an initial test.

Special district litigation is pending or underway in many state court systems. Unlike the IRS ruling, which may not formally be the basis for precedent, both good and bad legal standards and tests will slowly emerge from these cases. Landowners, homeowners and banks are exploring options to recover substantial financial losses where these districts have not performed as planned. Without concluding that the circumstances at The Villages create new legal defenses or avenues in the state courts, several of the disputes involve claims about the proper interests of the controlling parties. In this context, the processes and sequence of actions by which the largely privatized behavior of a group may taint an otherwise public business becomes a compelling argument to reexamine the terms of unwanted or suspect agreements.

Particular to the circumstances posed by The Villages, strategic planning absolutely must consider the possibility that the community development district or a like unit of government implemented to support a largely non-residential project or activity *may not* be deemed qualified as an issuer of tax exempt debt. Although other special districts with a comparable commercial orientation may operate with fuller transparency and greater regard to public stewardship, the situation presented by The Villages does not seem subject to nuance. Such a possibility could curtail opportunities for some real estate projects to form special districts and to rely upon their tax exempt debt as a source of financial support, much in the same way private activity rules already limit such debt. The largest projects, involving a broad mix of uses or activity, seem the most vulnerable now.

For both existing and new real estate projects launched through a special district, it seems reasonable to posit that it will become more difficult to price or sell bonds intended for the tax exempt market. Where the vehicle is being questioned, the pricing advantage normally attached to tax exempt debt should begin to decline.

Subtle evidence already points in this direction. As recently as July 14, 2013, Disney's powerful Reedy Creek Improvement District (government agent for Florida's Disney World and much of the development there) was obliged to distinguish its situation from that of The Villages in anticipation of a pending $360 million bond issue. By reflexively distancing itself from the unfortunate circumstances at The Villages, Reedy Creek acknowledges awareness about the exposure raised by the current IRS ruling. At a meeting of one CDD in Florida where The Villages matter was raised, an advisor commented, "I simply don't see how a bond or disclosure counsel could opine on the tax exempt status of *any* debt issue with characteristics like The Villages."

Then there are the bondholders—those who already have made investments, acquiring financial instruments from special districts anticipated to be tax exempt. These existing bond owners positioned in securities based on special district real estate projects, related activities or facilities of a comparable non-residential form, may find it more difficult to divest their holdings. Of course, steep discounts for these assets will affect the marketplace for future debt. The Reedy Creek offering scheduled for August may offer clues about the premiums, if any, that may burden these kinds of issues.

POSTSCRIPT

Irony weaves through what is really a dissent about the appropriateness of tax exempt debt for the varied purposes described. The more regulated states such as Florida demand the largest projects absorb their own costs, a challenge to the real estate community because of the financial requirements, but a logical nod to long-term community sustainability. Other states are calling for increased private participation in the provision of the most important infrastructure, especially the transportation network. However, the federal framework virtually precludes tax exempt debt from being channeled into privately controlled enterprises other than through the most elaborate legal schemes.

The special districts described here are, in the main, simple vehicles for promoting coveted public and private development. They could be a prototype of almost any instrumentality used to implement some form of public and private initiative. In the case of Florida, the enabling legislation for its special districts affirms as much. If the IRS ruling is remotely indicative, it hints the policies of

the state and federal governments are very much apart on several key issues critical to bringing additional private capitalization to major development activities.

Any knowledgeable opinion is welcome at this point but it would be disingenuous to declare large master-planned communities like The Villages will no longer be constructed as the result of changes in tax code. The largest ones may be fewer in number. Those that are developed are likely to be increasingly expensive. However, their existence may be threatened more by a growing interest in the alternative urban experience. The larger planned projects will evolve, and in the absence of a debt structure provided by tax exempt financing, the market will force prices to move accordingly. In large part, the master-planned community always has been something of an elitist enclave. As prices rise, their costs will make them more prohibitive, exclusive, or segregationist, depending upon your social perspective.

Regardless of the way matters are resolved at The Villages, the disputed infrastructure *does exist* and apparently functions very well. Even with the accumulated debt experienced by many of the failing special districts, they have created valuable assets capable of supporting subsequent development.

What seems lost in the ruling is a cogent policy on the preferred form of ownership for the facilities in question and the best means of maintaining them over time. If local governments find it desirable to offload the costs of these facilities to a specific user, the shift is a financial burden removed from other members of the broader community and rationally a public benefit recognized as such by Florida case law, perhaps by case law in other states. Once the costs are shifted, they are removed from the public's balance sheet directly to the beneficiaries. The further public benefit is that limited public financial resources are released for purposes where private capital may be less inclined to stray, including upgrades to other infrastructure. Practically speaking, if the costs of constructing and maintaining infrastructure—all built to specific local government standards—can be passed to discrete users, it is worth reevaluating the measures and tests of "publicness." Alternatively if these costs can't be pushed back to the users, public bodies are left to examine their competing service and financial obligations. ■

ENDNOTES

1. Internal Revenue Service National Office Technical Advice Memorandum Index (UIL) No. 103.02-01 CASE-MIS No. TAM-127670-12.

2. Op. cit. p. 10.

3. Ibid.

4. Ibid.

5. Op. cit, p. 8.