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Market Groups, Regulators Clash Over Political Subdivision Rules.

WASHINGTON – The Internal Revenue Service and Treasury Department's proposed rules on political subdivisions are "overly restrictive" and "misguided," and should be withdrawn or reproposed with a much narrower scope, municipal market groups told the agencies on Monday.

The complaints came during the agencies' joint public hearing over a proposed new definition of political subdivision that has drawn sharp criticism since it was first proposed in February.

Representatives from groups including the Government Finance Officers Association, the Securities Industry and Financial Markets Association and the National Association of Bond Lawyers said the proposed political subdivision rules are unnecessary and could potentially upend much of the muni market.

"We believe the approach taken is misguided," said Scott Lilienthal, a former president of the National Association of Bond Lawyers. "It would create continued uncertainty in the financial markets."

Pat McCoy, the director of finance for the Metropolitan Transportation Authority in New York who spoke on behalf of GFOA, said the group, like others, has been unable to fully grasp the reason for requiring a political subdivision to have a government purpose "with no more than an incidental private benefit."

"Our view is this adds a new layer of incidental private benefit that we were feeling was ambiguous and difficult to define," McCoy said.

Historically, the determination of whether an entity was a political subdivision was based on whether it had the right to exercise a substantial amount of at least one of three sovereign powers: eminent domain, taxation, and policing.

The proposed Treasury and IRS regulations would add two new requirements – that political subdivisions serve a governmental purpose "with no more than an incidental private benefit" and that they be governmentally controlled. To be governmentally controlled, a political subdivision would have to be controlled by a state or local governmental unit or an electorate. Whether an entity serves a governmental purpose would be based on whether it carries out public purposes stated in its enabling legislation and provides no more than incidental private benefit.

The new rules were proposed in response to concerns about who was controlling political subdivisions, John Cross, the Treasury Department's associate legislative tax counsel, said Monday. Some IRS audits found that developers or other private entities were wielding significant control over political subdivisions and this raised concerns among numerous federal officials.

"A core policy goal of the proposal was to enhance accountability in a targeted way," Cross said. "We wanted to add safeguards to ensure that an unreasonably small number of people do not control

political subdivisions."

But several speakers at the hearing, including Michael Decker, managing director and co-head of munis at SIFMA, said the current definition is sufficient and does not need any amendment. Decker said the new rules would create "substantially higher" financing costs for local governments in two ways: either investors would pay less for the bonds, creating higher yields, because the bonds would pose more risk or issuers would simply have to issue taxable bonds.

The taxable market would be entirely different due to expectations about issuance size and cash flow structure, he said.

Several of the ten speakers called for a full withdrawal of the rules without suggesting any alternatives, which Cross challenged as unconstructive. Several of those speaking on behalf of utility organizations said the abuses perceived by Treasury and IRS over private parties' control of political subdivisions do not seem to apply to them.

Thomas Devine, general counsel for the Airports Council International – North America, called for more targeted rules that wouldn't disturb what he called "non-problematic" entities like airport authorities.

"We believe there is a bullseye on our back," Devine said. "We believe we are not the subject of your concerns."

In response, Cross said the IRS is not targeting airports or other similar agencies.

That message was echoed by Erica Spitzig, deputy general counsel for the National Association of Clean Water Agencies, who said that the new definition could threaten access to the tax-exempt bond market for water and sewer issuers.

Spitzig said 48 states used tax-exempt bonds to fund sewer and water projects in 2012, a testament to their importance in public infrastructure.

David Schryver, executive vice president of the American Public Gas Association, also called for the withdrawal of the rules, which he said would eliminate the ability for communities to purchase gas with tax-exempt financing.

"Our message is the proposed regulations throw the baby out with the bathwater," he said.

The four-member panel of IRS and Treasury officials said they would consider the comments in finalizing the rules, but also defended much of what was proposed.

Spence Hanemann, an IRS attorney, said the rules were developed to "limit undue private control," while Timothy Jones, senior counsel for the IRS, said the agency was "particularly interested in development districts with a single owner."

Hanemann called the proposed rules "prospective," stressing that they would not go into effect for three years if and when they are finalized. He did not say whether the agencies would withdraw, repropose or leave the current proposed rules unchanged before they are finalized.

Other speakers included: James Thompson, mayor of Sugar Land, Tex.; T.J. Sullivan, a former IRS official and current lawyer with Drinker Biddle & Reath representing Clemson University; and Bond Dealers of America director of federal policy John Vahey.

Vahey was particularly concerned about the public purpose test. “It introduces a level of subjectivity and a significant level of uncertainty,” he said, adding that the proposed regulations would also raise the costs of infrastructure projects.

The IRS and Treasury panel also included Diana Imholtz, special counsel for the IRS.

The hearing follows months of criticism leveled at the Treasury and IRS over the proposed rules on political subdivisions.

The agencies received a total of 124 written comments from groups including the NABL and port authorities who argued the new regulations threaten the tax-exemption of many entities long considered political subdivisions as well as the tax-exempt status of their bonds.

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By Evan Fallor

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