May 23, 2016

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attention: CC:PA:LPD:PR (REG-129067-15)

Submitted to www.regulations.gov (IRS REG-129067-15)

Re: Comments Regarding Proposed Regulations Defining Political Subdivisions

The Securities Industry and Financial Markets Association ("SIFMA") is pleased to provide comments with respect to the proposed rulemaking (REG-129067-15) published in the Federal Register on February 23, 2016 (81 FR 8870), as corrected on March 9, 2016 (the "2015 Proposed Regulations"). The Proposed Regulations provide guidance re-defining the definition of political subdivision for purposes of entities that may qualify as issuers of tax-exempt bonds under section 103 of the Internal Revenue Code of 1986, as amended (the "Code").

SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $20 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

As described in detail below, we believe that the position in the Proposed Regulations is not supported by existing legal authority and that the Regulation's departure from the longstanding principle used to evaluate whether an entity qualifies as a political subdivision is unwarranted. SIFMA believes that a completely new standard for defining which entities qualify as political subdivisions for purposes of issuing tax-exempt bonds is unnecessary would be disruptive to the market. As also detailed below, the new standard would substantially hinder financing of significant infrastructure needs in many states and local governments due to increased costs to issuers arising from higher interest costs for the same projects in the taxable market or a risk premium demanded by the market because of the uncertainty created. For these reasons, we urge the Internal Revenue Service ("IRS") to withdraw the proposal.

Also for these reasons, SIFMA appreciates the efforts of the Treasury Department and the Internal Revenue Service ("IRS") personnel which resulted in a change in the effective date of the Proposed Regulations so that they apply prospectively.

Request to Testify

In addition to offering our views on the Proposed Regulations, this letter serves as our request to testify at the hearing on the Proposed Regulations scheduled for scheduled for June 6, 2016, at 10:00 a.m.

A. Proposed Regulations: Redefining Which Entities are Political Subdivisions

For interest on a bond to be excluded from gross income for federal income tax purposes, the bond must be a "state or local bond" under section 103(a) of the Code. Treas. Reg. § 1.103-1(a) provides in part that: "[i]nterest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "State or local governmental unit") is not includable in gross income."

The inquiry into whether an entity qualifies as a political subdivision for federal income tax purposes has been based on the determination of whether the entity is a governmental entity under state law that has been delegated the right to exercise one or more of the sovereign powers: the power of taxation, eminent domain, and police power, as set forth in *Comm'r of Internal Revenue v. Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944). In a long line of revenue rulings, the IRS has held that an entity does not need all of the powers but must have the ability to exercise a substantial amount of at least one of these powers.

Treas. Reg. § 1.103-1(b), promulgated in 1972, further expands the definition of permissible issuers and provides that the term "political subdivision" denotes any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign powers of the unit. The regulations go on to state that, as thus defined, a political subdivision of any state or local governmental unit may or may not include special assessment districts so created such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement and similar districts and divisions of any such unit. It is clear that since 1972, the tax regulations contemplated special districts are political subdivisions solely on the basis of having been delegated the right to exercise part of the sovereign powers as political subdivisions.

The Proposed Regulations would impose two new requirements on an entity: the entity must serve a governmental purpose and must be governmentally controlled. The determination of whether an entity serves a governmental purpose is based on whether the entity carries out the public purposes set forth in the entity's enabling legislation and whether the entity operates in a manner that provides a significant public benefit with no more than incidental private benefit. The Proposed Regulations would require that control be vested in either a general purpose state or local governmental unit or in an electorate established under an applicable state or local law of general application. If a small faction of private persons controlled an electorate, as defined in the Proposed Regulations, that electorate's control of the entity would not constitute governmental control of the entity. These additional requirements would change the longstanding analysis used for determining whether an entity would qualify as a political subdivision and would do so to the detriment of state and local governments.

B. Effect of Proposed Regulations on Financing Infrastructure

Entities that qualify as political subdivisions are used to finance critical infrastructure needs which include, among other items, roads, fire protection facilities, library, irrigation, conservation, storm and sanitary sewage, wastewater treatment, solid waste, water supply, electric power and utilities. A number of states including, among others, Alabama, Arizona, Texas, Colorado, California, Florida, Illinois, Nebraska, Virginia and Missouri have historically enacted legislation delegating a substantial amount of

one or more of the sovereign powers to developers or similarly named districts to provide the public infrastructure in lieu of the city or county issuing debt. As the 1972 regulations recognized, special entities are an important and an efficient vehicle for issuing debt to finance public infrastructure for state and local governments. Historically there has been a viable market for public infrastructure debt issued by special districts, with experienced market professionals and a knowledgeable bondholder community within the tax-exempt debt market to purchase this debt.

The new standard for defining which entities would qualify as political subdivisions would have chilling effects on special district financings which are a long-standing and effective mechanism for financing new public infrastructure in many states. The Proposed Regulations, if finalized, would result in a substantial decrease in the amount of new infrastructure that would be developed if the special district issuers could no longer qualify as political subdivisions due to the additional tests.

Under the Proposed Regulations the market for public infrastructure bonds would be less efficient because of the uncertainty as to whether the status of the issuer of the debt would be challenged by the IRS under ill-defined standards. The new definition would require more disclosure as to the potential risks associated with an IRS audit or loss of tax-exemption of the bonds. Investors would likely charge a risk premium on the interest cost or forego purchasing the bonds because there would be uncertainty as to whether an issuing entity would qualify as a political subdivision. Moreover, some states or local governments might choose to forego using special district financings to finance needed infrastructure or may forgo making needed infrastructure improvements.

Debt limits on traditional state and local issues may prevent or severely limit issuance of tax-exempt debt, which is one of the traditional reasons special districts have been used. States or local governments would choose to or must use special districts to issue debt may be forced to issue taxable debt which would result in increased costs due to higher interest costs for financing, which in turn might prevent the financing from occurring or reduce the needed infrastructure that can be financed.

In addition, the efficiency of the market would be reduced because taxable investors are unfamiliar with debt for these types of projects and would likely charge higher rates than is appropriate for the credit risk presented. The market for taxable municipal debt is very different in nature than the tax-exempt market, with different categories of investors and different product features. Taxable investors, for example, generally are less interested in small issue sizes, which are characteristic of the tax-exempt market. During the 10-year period 2006-2015, state and local districts of all sorts issued $580 billion of long-term, tax-exempt bonds to finance a wide variety of infrastructure, according to Thomson Reuters/SDC data. Not all these districts would have been directly affected by the Proposed Regulations had they been in effect during that period. If just half of that issuance had been required to be sold as taxable bonds as a result of the Proposed Regulations, we estimate that those local government entities would have faced an additional $87 billion of interest cost over the life of the bonds assuming a 15-year average maturity and a two-percent differential between taxable and tax-exempt rates.

C. Incidental Private Benefit Test in the Governmental Purpose Requirement Should be Deleted

We urge the IRS to fully withdraw the Proposed Regulations. If, however, the IRS does not withdraw the Proposed Regulations and proceed to finalize the proposal, we urge several key changes.

The Proposed Regulations provide that whether an entity serves a governmental purpose would be based on, among other items, whether the entity was created for public purposes that are set forth in

enabling legislation and whether the entity operates in a manner that "provides significant public benefit with no more than incidental private benefit."

We believe the federal government should not attempt to define a federal standard for what constitutes a governmental purpose. Rather, the question of what constitutes a governmental purpose should be determined by reference to state or local law. Since state requirements and needs change over time, the concept of public purpose needs to be broad and flexible and states should be given significant discretion to determine what qualifies as a public purpose. If a state or local law determines that an entity serves a governmental purpose that should be respected for purposes of federal law. The market should not be placed in a position of determining how the IRS would view the particular purpose.

Furthermore, the concept of "no more than incidental private benefit" appears to be similar to the concept used in the exempt organizations context or could be viewed as trying to borrow from the private activity bond regulations concept of "special economic benefit" in Treas. Reg. § 1.141-3. Trying to determine whether an entity provides "no more than incidental private benefit" has presented challenges in the section 501(c)(3) area and is essentially a facts and circumstances test. It is not clear how this concept related to an exempt purpose would be applied in the determination of whether an entity has a "governmental purpose," particularly where most or all improvements would be beneficial to the local community, which will include private parties. The fact that roads are constructed for a special commercial district does not mean the primary benefit of the roads will not be a public benefit to employees, customers and nearby residents of the commercial district.

Not only does the term "no more than incidental benefit" appear to be a lower threshold than the one in the existing regulations for determining private business use but it also is contrary to the existing rule in Treas. Reg. §1.1.141-3(d)(4) which provides that use by an initial development period by a developer for an improvement that carries out an essential governmental function is not private business use in certain circumstances. Additionally, this test is contrary to the existing private activity bonds rules which in the case of qualified private activity bonds contemplate that a governmental purpose can involve a significant private benefit. To the extent the IRS and Treasury have concerns about private benefit, the concerns should be addressed by the private activity bond rules rather than by re-defining the criteria for an entity to qualify as a political subdivision eligible to issue tax-exempt bonds.

Because there is no real guidance on what is "more than incidental private benefit" for political subdivisions, the market will presume that a development district would always be viewed by the IRS as a presenting more than incidental private benefit to the developer of the community covered by the development district. We believe that under this new standard, the IRS could argue that private benefit exists in almost all special district financings. The marketing of these bonds will be adversely affected in any economic development project such as a special district and tax increment financing because the bonds would be viewed as being at risk of losing tax-exemption, if such bonds can be sold at all on a tax-exempt basis.

More importantly, without clear guidance it will be difficult for underwriters and their counsel to know what kind of due diligence will be needed to ensure that bonds will be tax-exempt when they are issued. Additionally, bond counsel will be unable to give an unqualified opinion and offering documents will have to cover the risk of uncertainty as to whether an entity would be determined by the IRS to have more than an incidental private benefit.

D. Requirement of Governmental Control Needs to Be Changed

The Proposed Regulations require that control be vested in either a state or local governmental unit possessing a substantial amount of each of the sovereign powers and acting through its governing body or through its duly authorized elected or appointed officials in their official capacities or an electorate established under applicable state or local law of general application, provided the electorate is not a "private faction".

The Proposed Regulations establish a safe harbor for determining governmental control by stating that an electorate would not be deemed to be a private faction if voting power needed to control the outcome (i.e., a majority of the electorate by voting power) was disbursed among at least 11 persons. The Proposed Regulations provide that an electorate will be treated as a private faction if three private persons with the largest share of votes can determine the outcome of an election, regardless of how the other voters vote. In scenarios falling between these two thresholds, the facts and circumstances are evaluated to determine governmental control.

The requirement of "governmental control" described above is a departure from existing case law and IRS rulings which focus on whether sovereign powers have been delegated to an entity in analyzing if it qualifies as a political subdivision. In *Shamberg*, the seminal political subdivision case, the court did not address control by a governmental unit or accountability to the general electorate. Also control has never been a separate requirement for an entity to qualify as a political subdivision.

This test in the Proposed Regulations is arbitrary, not based on any specific authority and ignores the procedures which special districts are subject to in the first instance by a state or local entity forming the district. Delegating some or all of its sovereign powers is not an exercise of governmental authority that is taken lightly, as each of the sovereign powers is extremely important to an electorate. Furthermore, under the safe harbor in the Proposed Regulations, some special districts would never have the required number to qualify as a political subdivision even though they would be permitted to be set up as special districts under state law and have been delegated a substantial amount of an important sovereign power, such as eminent domain or taxing power. A particularly troublesome aspect of the new control requirement is that it would mean that commercial districts would be excluded from ever qualifying as political subdivisions. For years, states and local governments have financed public infrastructure in commercial districts with tax-exempt debt issued by these districts to which they have delegated a substantial amount of at least one sovereign power. The reasons for radically changing what entity a state or local government may choose to finance public infrastructure cited in the preamble to the Proposed Regulations does not justify the new requirements.

Moreover, any changes to the definition of political subdivision must also consider situations where, due to circumstances outside of the control of the parties, such as a financial crisis or a natural disaster, a development district does not transition following an initial development period into a district that complies with the regulations.

In addition, the Proposed Regulations do not address situations where an issuer might initially qualify under the control requirement, but due to changes in the population outside the control of the issuer or redistributing, the issuer would no longer satisfy the control requirement and therefore would not qualify as a valid political subdivision.

E. Development Districts

The preamble language recognizes that many development districts may operate during an initial development period under the direction of a board elected by one or two private developers without

other governmental control and that the governmental control requirement may present challenges for such development districts. The preamble states that the IRS and Treasury are concerned about the potential for excessive private control by individual developers, the attendant impact of excessive issuance of tax-exempt bonds and inappropriate private benefits from the federal subsidy.

The Proposed Regulations state that the IRS and Treasury seek public comments on whether it is necessary or appropriate to permit such districts to be political subdivisions during an initial development period; how such relief might be structured; and what specific safeguards might be included to prevent against potential abuse.

For the reasons described above, SIFMA believes these concerns and the solutions of the Proposed Regulations are misplaced. IRS and Treasury have other regulations, including the private activity bond regulations which are well-developed after being in place for almost 20 years to prevent abusive transactions. Investors should not be asked to bear the tax risk, which would in itself result in financial burdens for issuers in the form of higher risk premiums.

While we do not believe it is necessary to make further changes to existing regulations, we believe one possible alternative might be to require some sort of governmental hearing similar to the public hearing required under section 147(f) of the Code prior to the establishment of a special district.

F. Conclusion

SIFMA appreciates the efforts made by Treasury and IRS to respond to industry requests for guidance on what constitutes a political subdivision. However, as outlined above, the Proposed Regulations add new requirements that if implemented would severely hinder new development and we ask that the Proposed Regulations be withdrawn.

Please feel free to contact us with any questions.

Sincerely,

Michael Decker
Managing Director