BDA Bond Dealers of America

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Submitted Electronically

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: (REG—129067) Definition of Political Subdivision

Dear Sir or Madam:

On behalf of the Bond Dealers of America ("BDA"), I am pleased to submit this letter in response to the filing of (REG—129067) to redefine 'political subdivision' for the purposes of tax-exempt bonds. BDA is the only DC-based association representing the interests of middle-market securities dealers and banks focused on the U.S. fixed-income markets. Furthermore, BDA would like this letter to serve as it's request to testify at the June 6, 2016 public hearing on the proposed definition of 'political subdivision'.

BDA members are concerned that, as drafted, the proposed regulations are unnecessarily restrictive and, as a result, the proposal will disrupt the ability of many communities to build valuable public infrastructure projects and will increase the cost of financing infrastructure projects as some political subdivisions would unnecessarily lose the ability to issue tax exempt bonds. Therefore, BDA believes that an overly burdensome 'political subdivision' definition would create an unnecessary burden for the public. We urge the IRS and Treasury to withdraw these rules and release a new set of proposed regulations that reflect the concerns expressed by BDA and other participants in the municipal bond market.

The proposed regulation amends a century of legal, regulatory, and legislative precedent that has allowed political subdivisions to issue tax-exempt bonds if certain criteria are met. BDA understands that the federal government has a responsibility to ensure that the tax exemption is not abused. However, as drafted, BDA does not believe the proposed rule would achieve the stated goals of clarifying the definition of 'political subdivision'. Nor would the proposal provide certainty for issuers. The proposed rule would unnecessarily disrupt the ability of projects serving the public interest, including hospital, school, road, water, sewer, gas, and electric projects to access the tax-free debt capital markets in the future and cause significant confusion amongst issuers, legal

professionals, underwriters, and investors about the current tax status and investment quality of the outstanding issuances of political subdivisions. These destabilizing factors outweigh the potential benefits of the proposal as drafted.

Additionally, BDA believes that the IRS already has the ability to identify projects with excessive private control and prohibit those political subdivisions from accessing the tax-exempt bond market, particularly under the private activity bond limitations. Therefore, BDA does not believe a new federal standard to replace a well understood federal regulation is necessary at this time, especially when states have well established, accountable, and sound structures for political subdivisions. Although we understand the belief that it is reasonable to require that political subdivisions possess sovereign powers, have a public purpose, and are controlled by a governmental entity, the manner in which these requirements are detailed in the proposed regulations makes it clear just how difficult these concepts are to implement in a practical, non-disruptive manner.

BDA believes that the implementation of a public purpose test through a requirement of a significant public purpose and a prohibition on any 'incidental private benefit' in the proposed rule will harm the ability of beneficial public projects to be financed.

BDA is concerned with the proposed standard for how the IRS has attempted to ensure that the benefits of political subdivision projects accrue to the public, as opposed to private individuals. BDA members share the goal of ensuring that the public is enriched via the funding and development of value-adding public projects. However, the language of proposed section (c)(3) does introduce a level of subjectivity that would threaten the economic viability of development projects and inject a significant level of uncertainty for issuers, investors, underwriters, and counsel. The proposed definition would increase legal costs for political subdivisions, including smaller political subdivisions, that may be required to fund increased legal fees to document or demonstrate a project's public purpose in a burdensome way. a This portion of the regulations goes far beyond the broadly defined "public purposes" that have been sufficient in the past both in the political subdivision context and elsewhere under the Internal Revenue Code and regulations.

The proposed section 1.103-1 states:

"*The determination of whether an entity serves a governmental purpose is based on, among other things, whether the entity carries out the* ***public purposes*** *that are 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*** (emphasis added)."

We believe it should be sufficient to require that an entity carries out a public purpose. The terms "significant public benefit" and "incidental private benefit" raise significant concerns. These terms are undefined in the regulation. BDA believes the uncertainty introduced by the language proposed by the IRS would cause a disruption in the ability of political subdivisions established by state and local governments to issue tax-exempt bonds. More specifically, there is no existing tax law guidance for governmental entities to rely on to determine whether they are providing a significant public benefit or to analyze the many different ways in which governmental entities do, in fact, assist private entities (whether with tax-exempt bonds or otherwise). Stated simply, most governmental entities have as part of their mandate, providing different types of assistance to non-governmental persons. Surely the IRS does not intend to limit this type of governmental function.

We recognize that one of the types of entities that have caused the IRS concern is community development districts. Assuming that such a district can satisfy the governmental control test, the entity must still satisfy the governmental purpose test as set forth in the proposed rules, with little specificity to use in this context. For example, consider a community development project in which a municipality and a developer have partnered to build a new community. The project starts with a developer buying a piece of land and then the newly formed political subdivision would issue tax-exempt bonds to fund the initial infrastructure development. The land value of the development is immediately improved by the development of roads and the connection of the unsold housing lots in the new community to municipal electric, sewer, and water systems. Once the raw land is developed its value immediately increases. The developer benefits from the increase in land value before any prospective homeowner in the community is able to benefit from the use of the public services made possible and financed by the political subdivision partnership between the municipality and the developer.

As the development continues and houses are sold they are sold at a variety of different prices. Therefore, different private benefits will accrue to the developer depending on sales price and the value of future assessment payments pledged by the homeowner. Different sales prices and assessment levels will allow the dealer to amortize its debt load at different rates. So, the public benefit level and private benefit level will be variable depending on the present value of each home-purchase transaction in the community.

Under the proposed definition, it is unclear if the increase in the intrinsic value of the land that will take place when the initial land development is complete and the benefits that will result from the variety of the values of the homes purchased and assessment levels will trigger a private benefit that will be considered by the IRS to be

greater than 'incidental'. This is a significant question that the proposed rule raises and provides no guidance on.

BDA appreciates the fact that IRS requested comment on the potential for relief for development districts. However, that request for comment mostly focuses on the issue of control and not governmental purpose. So, it is unclear whether relief to allow a different level of private control at the initial phase of a community development would acknowledge the issues raised above regarding the potential for benefits to accrue to private parties that the IRS would consider greater than 'incidental'. BDA suggests the IRS amend the language of the proposed rule to ensure that the basic economic realities of community development districts are able to continue. BDA does view reasonable benefits accruing to private individuals to be part of the incentive structure that allows valuable communities to be developed across the United States—to the benefit of the public.

As stated above, we believe a more targeted regulation focused on new developer districts (and other specific areas of concern) should be adopted. With respect to new developer districts, we suggest the adoption of a safe harbor under which such a district is treated as a political subdivision if the following requirements are satisfied:

(1) It is reasonably expected by the governmental entity that created the district that it would not be controlled by a small number of voters within a reasonable period (e.g., five years),
(2) The governmental entity creating the district approves the district and its purposes with some specificity and including approving the geographic boundaries and scope of the improvements to be financed, and
(3) The district is created to finance/serve an essential governmental function and is provided with one or more sovereign powers. The requirements related to the expectations of the governmental entity creating the district would have to be reasonably based on that entity's independent determination or the analysis of third party that is independent of the developers associated with the district.

BDA believes the current definition of 'political subdivision' allows the IRS to assess the level of governmental control of a political subdivision and that the proposed regulation should be drafted to address only those types of entities that raise concerns under existing law.

Currently, a political subdivision must be delegated the right to use a not unsubstantial amount of one of three sovereign powers to police, eminent domain, or to

tax. And political subdivisions operating in different states can be structured in a variety of ways based on state laws. Subdivisions are established with a variety of levels of dependency between the local government and the districts. In some instances, the political subdivision is directly controlled by a city council or board of governors. Other times, political subdivisions have a structure that is more independent of the local government.

BDA's view is that the proposed governmental control requirements represent a "one-size-fits-all" federal approach that cannot work given the huge variety of structures employed by governmental entities. The likely result of this approach is a reduction in the level of tax-exempt bond issuance far beyond the level that is necessary for protecting against abuse of the federal tax exemption. Instead, the IRS should draft rules to address the type of entity analyzed in Technical Advice Memorandum 201334038 (*the "2013 TAM")* without attempting to rewrite rules that have been workable for decades for the vast majority of tax-exempt bond issuers. If certain structures allow for excessive private control it would be a better result for the IRS to draft narrowly tailored rules to address those issuances rather than upending the market in all fifty states with a federal approach that does not acknowledge the value of the structures set up by different states. BDA urges the IRS to not pursue a prescriptive, top-down federal approach to define 'governmental control'. The downside of the proposed approach is that fewer economically beneficial projects will be funded.

In conclusion, BDA believes the IRS has not struck the right balance between ensuring beneficial projects continue to be developed and protecting the tax exemption from abuse. BDA is neither a proponent of excessive private control, greater than incidental private benefits, or inappropriate tax-exempt bond issuance by private parties. However, BDA believes the approach IRS has taken is overly prescriptive. The language of the proposed governmental purpose section will likely have a chilling effect on development projects. Furthermore, the proposed government control section introduces a new federal standard that BDA does not believe is necessary and will result in a market disruption as states have to adjust from sound, legal structures to a federally mandated political subdivision structure.

Sincerely,

Mike Nicholas

Chief Executive Officer