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Internal Revenue Service
CC:PA:LPD:PR (REG-129067-15)
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments on Proposed Political Subdivision Regulations

Dear Commissioner:

The Internal Revenue Service (the "IRS") recently[1] issued proposed regulations (the "Proposed Regulations") regarding the definition of political subdivision for purposes of tax-exempt bonds. The Northern California Power Agency ("NCPA") urges the Proposed Regulations either be withdrawn or modified as discussed below. The Proposed Regulations are contrary to well settled law and, as such, create unnecessary confusion, uncertainty and do not improve administration of the federal income tax laws.

A. Introduction

Established in 1968, NCPA is a non-profit joint powers agency that generates, transmits, and distributes electric power to and on behalf of 15 municipalities, special districts, and rural cooperatives in Northern and Central California. NCPA serves more than 650,000 customers, representing 3% of California's electricity demand. NCPA was formed pursuant to the California Joint Exercise of Powers Act, Government Code 6500 et seq. which authorizes two or more public agencies to jointly exercise any power common to those agencies. It was formed to finance, own and operate electric facilities including power plants, transmission lines, administrative and other electric facilities. Since its formation, it has issued over $6.6 billion of tax exempt and other tax advantaged bonds to finance generation and transmission projects for its participating member governmental utilities. While there are any number of important public, practical and financial purposes for the formation and utilization of NCPA, and other similar JPAs, among the most important is that NCPA has provided its Members with an efficient vehicle to allow them to join together and jointly finance, own and operate electric projects that are larger than any one Member could utilize, thus providing significant economies of scale and ease of financing for these projects.[2]

The NCPA structure, as a JPA whose Members are all, themselves, political subdivisions of the State of California, does not present a concern for the IRS and Treasury given its inherent and obvious governmental structure, as described below. Thus, NCPA is highlighting its structure and is requesting that if the Proposed Regulations are not withdrawn, that final regulations make it clear that JPAs, such

[1] February 23, 2016

[2] Using JPAs to finance large power projects by issuing tax-exempt bonds is a crucial and common vehicle for financing projects, especially large jointly-owned projects that no one public agency could easily take on alone.

as NCPA, satisfy the "governmental control" portion of the final regulations. (As NCPA appears to meet the other requirements set forth in the Proposed Regulations, it will continue to qualify as a political subdivision.)

Activities of Members. NCPA, as is the case for most JPAs, was formed with its membership consisting of two or more public agencies such as cities, counties and other types of municipal corporations. As mentioned, the NCPA Members are themselves political subdivisions of the State of California. Pursuant to the terms of its Joint Powers Agreement, the formation document for NCPA entered into by its Members, NCPA possesses the general powers to acquire, purchase, generate, transmit, distribute and sell electrical capacity and energy. Its specific powers include the power to enter into contracts, to acquire and construct electric generating and transmission facilities, set rates, issue revenue bonds and notes and acquire property by eminent domain. Under California law, NCPA has the power of eminent domain and NCPA has previously used its power of eminent domain in connection with at least one of its generation projects.

Members of NCPA have no financial or liability associated with the acquisition, construction, maintenance, operation or financing of any NCPA project. Rather, Members become obligated for payments with respect to an NCPA project only as "participants" with respect to such project. These obligations are set forth in a separate agreement among each project's project participants, such as a power purchase or similar agreement. This structure is used as not all Members participate in every project of NCPA. Only those Members participating in a particular project will be liable for debt service and operating and maintenance expenses of that project.

Activities of the Commission. NCPA's governing body consists of a Commission (the "Commission") which is composed of one representative from each Member, with each such representative being designated a Commissioner. The Commission controls the general management of the affairs, property and business of NCPA and is vested with all powers of NCPA. The Commissioners are responsible for various areas of administration and planning of the operations and affairs of NCPA. The overall management is under the direction of a general manager, who serves at the discretion of the Commission. NCPA, like other JPAs, is organized into divisions and consists of: (i) generation services, (ii) power management, (iii) transmission services, (iv) legislative and regulatory, and (v) administrative services. All of these divisions are controlled by the Commission.

Actions taken by the Commission are based upon the vote of a majority of the Commissioners, and for certain actions Commission approval may require a super majority. As mentioned, each Member appoints its representative to serve on the Commission and each Member has complete authority to appoint its Commissioner and to remove its appointee with or without cause. NCPA has no control over the Members' appointments to the Commission.

B. Background

Existing Treasury Regulation Section 1.103-1(a) generally provides that interest on obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof is not includable in gross income. Treasury Regulation Section 1.103-1(b) provides in part that -

> **The term "political subdivision", for purposes of this section denotes any division of any State or local government unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.**

In Commissioner v. Shamberg's Estate[3], the U.S. Court of Appeals for the Second Circuit identified three sovereign powers the presence or absence of which form the basis for determining whether an entity is a political subdivision, the power of eminent domain, the power to tax and the police power. The Court in Shamberg ruled that it is not necessary that all three of these powers be delegated, however, whatever powers have been delegated must be substantial in their effect.

The preamble to the Proposed Regulations provides in part that-

> **"[c]ommentators have requested additional published guidance, to be applied prospectively, on which facts and circumstances are germane to an entity's status as a political subdivision. The Treasury Department and the IRS recognize the need to clarify the definition of political subdivision to provide greater certainty to prospective issuers and promote greater consistency in how the definition is applied across a wide range of factual circumstances."**

NCPA does not believe that the existing regulations require clarification. Moreover, NCPA is not aware that other members of the public finance community have requested guidance or clarification in this area. To the contrary, the existing Treasury Regulations and related authorities have been more than adequate to address this subject matter.

The current Treasury Regulations regarding political subdivisions were promulgated in 1972.[4] The regulatory definition of the term "political subdivision" for purposes of tax-exempt bonds dates back to the Revenue Act of 1936.[5] Moreover, the basic concepts and principles contained therein have a lineage dating back more than 100 years.[6] These concepts and principles have been subject to judicial review and affirmation.[7] NCPA is of the view that the definition of political subdivision provided in existing regulations is logical, administrable and provides the correct basis for such determination.

NCPA understands that the genesis of the Proposed Regulations relates to an enforcement action in the State of Florida otherwise described in TAM 201537023 (the "TAM"). The Proposed Regulations reflect a general trend by the IRS towards published guidance projects that have arisen out of its enforcement program. The Proposed Regulations reverse well established precedent. They also raise tax policy and technical questions that will be difficult to resolve, consuming time and resources of the Treasury Department, the IRS and the public finance community. NCPA believes that other paths exist for the IRS to successfully address any perceived abuses described in the TAM absent a wholesale

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[3] 144 F. 2d 998 (2d Cir. 1944), *cert denied*, 323 U.S. 792 (1945) (hereinafter, Shamberg).
[4] T.D. 7199, 1972-2 C.B. 34.
[5] Regulation 94, 1 Fed. Reg. 1802, 1818 (Nov. 14, 1936).
[6] U.S. Attorney General Opinion, 30 Op. Atty. Gen. 252, 253 (1914).
[7] See Shamberg, Commissioner v. White's Estate, 144 F.2d 998 (2d Cir. 1944), *cert denied*, 323 U.S. 792 (1945).

re-write of century old precedent which has served the federal government and the public finance community well. Moreover, as you are aware, given its practicality and judicial underpinning, the current definition of political subdivision for tax-exempt bond purposes has been adopted and followed by many other divisions of the IRS.[8] Accordingly, if finalized in its current form, the changes made by the Proposed Regulations will have a cascading and disruptive effect throughout the federal tax system.

C. Comments on the Proposed Regulations

The Proposed Regulations include the historical requirement that a political subdivision have the power to exercise at least one of the three recognized sovereign powers[9] but add two new requirements: (i) a governmental purpose, and (ii) governmental control. These two new proposed requirements, especially the latter, represent a material change in law that will create confusion, uncertainty and compliance issues as further described below.

1. Governmental Control. The Proposed Regulations provide that the entity must be controlled by: (i) a state or local government unit possessing a substantial amount of each of the sovereign powers acting through its governing body or through its duly elected/appointed officials, or (ii) an electorate established under State or local law of general application that is not a "private faction".

With respect to an electorate, an entity will be treated as controlled by the voters in the relevant jurisdiction, unless the outcome of the exercise of control is determined solely by the votes of an "unreasonable small number of private persons" (i.e., a private faction). Under the Proposed Regulations an electorate is a private faction if any three or fewer private persons that are members of the electorate possess, in the aggregate, a majority of the votes needed to determine the outcome.[10]

The Proposed Regulations provide that among rights and powers that "may" establish control, an ongoing ability to exercise one or more of the following constitutes control: (i) the right or power to approve and to remove a majority of the governing board of the entity, (ii) the right or power to elect a majority of the governing body of the entity in periodic elections of reasonable frequency, or (iii) the right or power to approve or direct significant uses of funds or assets of the entity in advance of that use.

Given the description of the manner by which NCPA is controlled by its Commission, it is unlikely that it will fail to satisfy any definition of "control." However, if the Proposed Regulations are not withdrawn, NCPA requests that final regulations provide a safe harbor regarding what rights and powers constitute control, rather than leave the question entirely open to subjectivity (focusing on the

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[8] The IRS has stated that the term "political subdivision" has been defined consistently for all federal tax purposes. See Rev. Rul. 77-143, 1977-1 C.B. 340 and Rev. Rul. 78-276, 1978-2 C.B. 256.

[9] As mentioned, NCPA has, and has used, its power of eminent domain.

[10] The Proposed Regulations contain a safe harbor which provides that an electorate is not too small if the smallest number of private persons who can combine to establish a majority of the votes necessary to determine the outcome of the relevant excise of control is greater than 10.

use of the word "may" in the Proposed Regulations). The provision in the Proposed Regulations that is of primary concern to NCPA is that to qualify as a political subdivision the entity is required to be controlled by "a state or local governmental unit." [11] The Proposed Regulations state that the requisite governmental control may be vested in a local government unit or an electorate established under applicable state or local law (or a combination thereof). Neither NCPA nor other JPAs have "an electorate," per se. However, all of its Members meet the requirement of having an electorate and are themselves political subdivisions (under any definition). Absent having an electorate and read literally, the Proposed Regulations require control be in a single state of local governmental unit. As that is not the case for NCPA, and most other JPAs, it may fail the third proposed test, unless there is a clarification of, or a change to the Proposed Regulations on this critical point.

As described above, control of NCPA is completely within the purview of its Commission, as the Commission has the ongoing right and power to direct all significant actions of NCPA. Moreover, each Member has complete control over its appointee to the Commission and each Member may remove and replace its representative on the Commission. However, no single Member has control over NCPA, such as the right to approve and remove a majority of the governing body of NCPA or the right to approve or direct the significant uses of funds or assets of NCPA. Specifically, NCPA is governed by its Commission, which is made up of one individual appointed by each of the Members. The Commission has the right to approve or direct the significant uses of funds or assets of NCPA, and therefore exercises control. No other entity or board, including any individual Member, has control in the manner that appears to be contemplated by the Proposed Regulations. Rather, NCPA is collectively controlled by its Members and then through its Commission.

NCPA requests that if the Proposed Regulations are not withdrawn that final regulations make it clear that entities, such as NCPA, satisfy the governmental control requirement.

2. Governmental Purpose- Activities of the Entity. The Proposed Regulations require that the entity serve a governmental purpose. The governmental purpose prong of the Proposed Regulations has two components: (i) that the entity serve a governmental purpose, and (ii) that the entity operate in a manner that provides a significant public benefit with no more than incidental private benefit.

Regarding the requirement that the entity serve a governmental purpose, the preamble to the Proposed Regulations provides in part that "[a] governmental purpose requires, among other things, that the purpose for which the entity was created, as set forth in its enabling legislation, be a public purpose and the entity actually serve that purpose" (emphasis added). The language in the Proposed Regulations is slightly different in that regard and provides in part that "[t]he 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 legislation" (emphasis added).

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[11] We observe that Section 1.103-1(c)(4)(ii) provides in part that "[c]ontrol is vested in persons described in paragraphs (c)(4)(ii)(A) or (c)(4)(ii)(B) of this section or a combination thereof" (emphasis added). Although the use of the words "persons' or "a combination thereof" could be interpreted as including more than one State of local government unit, other portions of the Proposed Regulations use the term "a State or local governmental unit". Given this uncertainty and alternative readings, clarification is being sought.

NCPA is of the view that the governmental purpose requirement of the Proposed Regulations, as currently drafted, is problematic in several respects. Historically, the Treasury Department has permitted State and local governments to define what activities or services constitute a governmental/public purpose. The Proposed Regulations appear to open the door to the federal government dictating or at least second guessing the governmental/public purpose of State and local entities. This uncertainty is partly derived from preamble language which requires that the purpose stated in the enabling legislation "be a public purpose" without any definition or expression of who and how that is determined. Although the text of the Proposed Regulations appears to indicate that the purpose of the entity will be deemed to be a governmental purpose if an entity actually serves the mission provided in its enabling legislation, the text is qualified by the phrase "among other things" (which is also used in the preamble). Without further explanation, the phrase "among other things" suggests an open ended facts and circumstances test to be applied by the IRS in making such a determination.

Any regulatory notion of what constitutes a "public purpose" must be flexible as the range and scope of government services will change over time and vary from State to State. Moreover, many services provided by State and local governments, such as the type of electric utility services provided by NCPA, are also provided by the private sector. The lack of a bright line between the types of services provided by governmental entities and the private sector (which vary from region to region) make the task of developing a regulatory definition of governmental/public purpose quite challenging. In that regard, NCPA believes that the delegation of one or more of the sovereign powers is sufficient for such entity to be deemed to be serving a governmental/public purpose.[12]

If the Proposed Regulations are not withdrawn, NCPA requests that the final regulations make it clear that any determination regarding a governmental/public purpose shall be determined exclusively and solely by State or local governments and that the phrase "among other things" be removed from the text of the regulations and the preamble.

3. Governmental Purpose – Incidental Benefit. Equally troubling is the requirement in the Proposed Regulations that the entity operate in a manner that provides "no more than an incidental benefit to private persons". The Proposed Regulations do not provide any objective standard or definition of what constitutes an incidental benefit. This limitation on private benefit, imposed at the issuing entity level for the first time, creates an entirely new standard in determining whether a governmental entity is a political subdivision. This new requirement raises numerous interpretative questions such as, what is a private benefit, when is private benefit determined and what metric is applied for determining whether such benefit is more than incidental. As you are aware, many basic public infrastructure projects provide some range of benefits to private parties, commercial entities and industrial businesses.

The preamble to the Proposed Regulations cites Revenue Ruling 90-74[13] that addressed a situation in which a group of political subdivisions within a State created and operated a separate organization to pool casualty risks. The question presented in the ruling was whether the income from

[12] See Seagrave Corp. v Commissioner, 38 T.C. 247 (1962). The Court in Seagrave stated that an entity "cannot be called a subdivision of the State unless there has been a delegation … of some functions of local government". Seagrave at 250.
[13] 1990-2 C.B. 34

the organization would be excluded from gross income under Section 115 of the Internal Revenue Code (the "Code"). In affirming the organization's tax-exempt status, as in numerous other Section 115 rulings, the ruling concludes that the employees of the participating political subdivisions will obtain no more than an incidental benefit from the organization. As further set forth below, while such a standard may be appropriate in determining the income tax status of an organization and its activities which are conducted "indirectly" by its political subdivision members, applying this standard directly to political subdivisions is in contravention of similar tax principles applied to political subdivisions by the IRS.

For example, in GCM 14407 (the "GCM"),[14] the IRS ruled that Section 115 of the Code is not applicable to income resulting from a State or political subdivision's direct participation in business or industry. Rather, the IRS has expressed the view that Section 115 only applies to income resulting from a State or political subdivision's ownership or control of a separate vehicle which engages in business (e.g., a corporation). According to the GCM, this position is based on the fact that it was assumed that Congress did not desire in any way to restrict a State's participation in activities that might be useful in carrying out projects desirable from the stand point of State government.[15] NCPA is of the view that the basic tax policy determination which precludes the application of Section 115 concepts to State and political subdivisions with respect to income exclusion should also apply for purposes of the tax-exempt bond rules.

The Proposed Regulations requirement that no more than an incidental benefit is provided to private persons is similar to the criticized and subsequently withdrawn general prohibition regarding "economic benefit" as set forth in 1994 proposed regulations under Code Section 141. Under the economic benefit test, a nongovernmental person could be treated as a private business user even if the nongovernmental person had no special legal entitlement to use the bond financed property. The Treasury Department and the IRS received many negative comments on the 1994 proposed regulations asserting that mere economic benefit is insufficient to give rise to private business use. In connection with the publication of the final Section 141 regulations, the Treasury Department and the IRS correctly determined to focus on the use of the assets financed pursuant to a special legal entitlement and not mere economic benefit.

In light of the many problems and challenges presented by the "incidental benefit" limitation of the Proposed Regulations, NCPA wishes to emphasize that the existing tax-exempt bond regulations under Code Section 141, which apply to the use of bond proceeds (and not the bond issuing entity itself), already contains a "private business use test" to determine whether the bonds are to be treated as tax-exempt governmental bonds or taxable private activity bonds. As a tax policy matter, the existing private activity regulations should be more than adequate to address whether or not a bond transaction finances excess private benefit and use. Indeed, the public finance community's reaction to the 1994 proposed regulations and the IRS' response thereto, demonstrates the sufficiency of the existing private activity rules to address any private business use concerns.

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[14] GCM 14407, C.B. XIV-1, 103 (1935). GCM 14407 has been superseded by Rev. Rul. 71-131, 1971-1 C.B. 28 and Rev. Rul. 71-132, 1971-1 C.B. 29, which adopt the position of GCM 14407.

[15] "It is suggested that Congress, in not taxing the income of States, may well have been motivated by a desire not to limit the activities in which State might otherwise engage. The line between those revenue-producing activities of a State which are "governmental" and those which are "proprietary" is one which is in its nature difficult to draw".... GCM 14407 at 106.

D. Conclusion

As discussed in detail above, NCPA is of the view that the Proposed Regulations disturb well settled law and, as such, create unnecessary confusion, uncertainty and do not improve administration of the federal income tax laws. Accordingly, NCPA strongly recommends that the Proposed Regulations be withdrawn. NCPA is of the view that the definition of political subdivision provided in existing regulations is logical, administrable and provides the correct basis for such determination. The existing Treasury Regulations and related authorities have been more than adequate to address this subject matter.

The basic concepts and principles regarding the determination of political subdivisions for federal tax purposes have a lineage dating back more than 100 years. These concepts and principles have been subject to judicial review and affirmation. NCPA believes that other paths exist for the IRS to successfully address any perceived abuses described in the TAM absent disturbing well settled law which has served the federal government and the public finance community well.

NCPA understands that the IRS has a concern with certain types of entities of how they operate and are controlled. If the Proposed Regulations are not withdrawn, then NCPA urges changes that will assure entities such as NCPA continue to be treated as political subdivisions.

We appreciate the opportunity to comment on the Proposed Regulations and would be happy to discuss these issues with you at your convenience. Please contact me at 916-781-4200 or Larry D. Sobel at 213-612-2421.

Sincerely,

Randy S. Howard, General Manager