

Thank You

It is my pleasure to address the members of NABL this afternoon. The last time I had the honor of this experience was more than 10 years ago, when I was with the U.S. Treasury Department's Office of Tax Policy.

I. Tax Policy and Tax Reform.

In preparing my comments, I could not help but reflect upon the state of Tax Policy in place 10 years ago and contrast that with the tax policy of today. In many respects, the tax policy affecting the public finance sector remains in a state of flux -- impinged by tax law changes and orthodoxy of the 1986 Tax Reform Act, a continued bias that the tax-exemption afforded municipal bonds is inefficient and a range of political crosswinds that make progress on public investments difficult. With a large federal deficit, a growing awareness regarding the lack of investment in critical infrastructure, together with the rise of other global economic powers the public finance sector is at the cross roads.

Each year, the American Society of Engineers publishes an infrastructure report card. In its 2010 Report, America's infrastructure received a cumulative grade of "D". Among the more notable aspects of the Report are grades of "D" in aviation, "D" in Schools, and "D-" in the areas of drinking water and roads.

According to the 2010 World Economic Forum's Report on Global Competitiveness, the US ranked **23rd** regarding the quality of its overall infrastructure behind such Countries as – Germany, France, Canada, Japan and Spain.

Given this reality, the US and its policy makers are at the critical juncture regarding ... how to increase the level of spending on infrastructure ... how it should be funded ... how it should be owned and how it should be operated --- which brings up the topic of Tax Reform.

The prospects for some level of Federal Tax Reform have increased significantly over the last 12 months due to a number of factors. One of those factors is the publication of the "Bowles – Simpson Report" in December of 2010. As you are aware, Bowles-Simpson was a deficit commission established by the President to examine the Country's long term fiscal position. Among the Commissions findings is the general notion that "America's tax code is broken and must be reformed".

The Bowles-Simpson Report endorsed the concept of raising revenues through repeal or curtailment of “Tax Expenditures” (*a subject that I will return too shortly*).

Although Bowles-Simpson did not endorse a specific tax proposal --- the Report does contain a "template “of a tax reform plan --- that template includes the repeal of the tax-exemption for municipal bonds.

Part of the process and maneuvering in the short term will depend on the actions of the so-called "super-committee" tasked with identifying an additional \$1.5 trillion in deficit reduction. For fiscal years 2008 to 2010, the federal revenues forgone through the issuance of tax-exempt bonds is estimated to exceed \$26 billion annually. In the hunt for revenue, no doubt that that the exclusion of interest on tax-exempt bonds could be characterized as a "special interest loophole" or "corporate welfare".

The current tax reform debate is somewhat unique in that it seems to be almost completely focused on "tax expenditures". The focus on tax expenditures takes into account only the revenue effect of a provision--and ignores the fact that many so-called tax expenditures add to a nations' production, efficiency, output and national wealth. Although certain so-called "tax expenditures" can and do benefit taxpayers with higher levels of income -- the true economic burden of a repeal of items like the exclusion of interest on state and local bonds and the charitable contribution deduction -- will in fact be borne by other than the wealthy -- in the form of higher taxes, higher interest rates for State and local financings and user fees.

On September 12 of this year, the Obama Administration released the "American Jobs Act of 2011". Unlike the Administration's 2009 Stimulus bill which did much to empower State and local governments by providing a range of public finance tools, the

Jobs Act takes a very different approach – an approach intent on capturing revenue and perhaps limiting the so-called inefficiency of tax-exempt bonds.

The Jobs Act generally limits the value of the federal tax exemption of interest on municipal bonds to 28% for certain "high income taxpayers".

The Jobs Act proposal is significant in a number of respects:

One - The Administration's proposal builds upon the proposition put forth by Bowles-Simpson --- that tax benefits associated with municipal bonds be examined, cut back or trimmed in some way.

Two - The proposal appears to not only apply to municipal bonds issued after January 1, 2013, but to be retroactive as well – by applying to all outstanding bonds regardless of the date of issue.

Drafters of the Jobs Act have failed to appreciate that the exclusion of interest on State and local government debt is a historic exclusion based on the tenants of federalism, as memorialized almost a century ago in the Internal Revenue Code of 1913.

Three - Limiting the tax benefits of the interest on State and local bonds to no more than what might be retained by a 28% marginal rate taxpayer will increase taxes on higher bracket holders – but such an action will likely raise the cost of capital for State and local government financings through the form of higher interest rates. Given a

higher cost of capital, it is presumed that governments will finance less infrastructure not more of it – hence adding to an otherwise gloomy outlook on the Nation's infrastructure report card.

Lastly and notably, the convention regarding the treatment of Section 103 as provided in the Jobs Act could perhaps represent a "grand compromise". A platform which does not go as far as Bowles-Simpson – a platform which raises revenue, and platform which attempts to wring inefficiency from the system as historically perceived by Treasury and CBO economists.

So How Might Tax Reform Impact Public Finance ---? In 2009 and 2010 the public finance industry underwent a "quiet revolution" with the implementation of various forms of direct-pay taxable bonds. Not many saw this coming -- as the "taxable bond option" had been beaten back in 1968, 1973 and 1983.

There are benefits to having a taxable bond option.

-- A taxable bond option increases the scope and scale of investors in the US public infrastructure market including pension funds and global investors.

-- In the event of a tax violation, the bond issuer (the party in interest) is also the "party at risk" for losing the tax benefit as contrasted with a disinterested bond holder.

-- The combination of a taxable bond option and tax-exempt bonds may better permit State and local governments to optimize their cost of capital, and in some instances drive down the cost as tax-exempt bonds are issued in smaller amounts.

Although the prospects for Tax Reform taking place are likely – I don't see the federal subsidy for State and local bonds being taken away – however, the odds of it being reshaped, reformulated, modified and changed in some manner – remain high.

At the end of the process, we could see a return of a two tier system – tax-exempt bonds combined with either tax-credit bonds or direct pay bonds.

Moving to a two-tier system presents an array of challenges to regulators, issuers and the market place. Hence, an efficient two-tier system needs to have similar rules and conventions. Importantly, any new or dual system cannot have certain unknowns if it is to flourish

Lastly, any tax reform effort focused on improving the nation's infrastructure must properly address the ills of the 1986 *Tax Reform Act* which are numerous. Given the creation of TE/GE, the Services focus on post-issuance compliance and the dramatic change in enforcement over the last decade, lawmakers may be more inclined to

reconsider some of the poor legislative decisions made 25 years ago effecting the public finance sector.

II. Post-Issue Tax Compliance

Speaking of post-issuance compliance, the IRS focus on post-issuance tax compliance continues to march forward in 2011. As part of that process, we have seen a growing array of tax questionnaires - with presumably more to follow---

Responding to these questionnaires presents a number of challenges for State and local governments, non-profits and municipal bond professionals.

Our clients are still a bit uncertain as to what this is all about; they are unsure if the questionnaire might be a pre-cursor to an audit; they are uncertain how to respond; and they don't want to check the "NO" box if it can be avoided.

Many issuers also inquire as to whether there is an express legal requirement to have written procedures regarding post-issuance tax compliance. In short, the answer there is "no"; on the other hand it is certainly within the purview of the IRS to inquire and review post-issuance compliance matters.

In my opinion, the IRS deserves credit for their soft contact initiative regarding post-issuance matters, their outreach efforts to issuers and trying to foster a

culture of compliance. Working through the questionnaires with clients is helpful and an instructive tool in fostering dialogue regarding the tax law and the range of issuer responsibilities. Fostering a culture of compliance and having our clients more aware of the tax rules – is ultimately good for the industry.

On July 1 of this year, the IRS released its final report on its tax exempt bond questionnaires regarding governmental bonds and 501(c)(3) bonds. Among its findings are that 501(c)(3) organizations have written formal procedures at twice the rate of governmental issuers. Frankly, I don't find this to be a surprising statistic.

In my view, this statistic is impacted by the fact that some governmental issuers do it all – power plants, hospitals, sewer and wastewater, education, docks, airports and on and on, crafting post-issuance compliance procedures for some large issues can be a very significant undertaking – in terms of outside expertise and issuer staff time.

Let's face it, for the majority of our clients, taking post-issuance compliance to the level aspired by the IRS tax questionnaires and the detailed reporting requirements in Schedule K is a high hurdle.

As a practical matter, the majority of issuer and conduit borrowers need outside expertise to adequately undertake the post-issuance function. Often, a less than full embrace of post-issuance responsibilities is not due to lack of will – but rather a lack of

resources. I suggest that the Treasury consider a regulatory change to assist issuers with the costs of post-issuance compliance. Perhaps a change in the manner in which the arbitrage yield is calculated to permit the recovery of compliance fees or in the form of recoverable administrative costs.

On the topic of questionnaires – the most recent questionnaire – regarding advance refunding bonds released in 2011– is more difficult to navigate through and I suggest that its tone is more aggressive as it asks certain questions which should generally be the domain of State and local governments. For example, the advance refunding questionnaire asks the following 2 questions ---

1. Explain how you identify and select bonds to be advance refunded? and
2. Once a prior bond issue to be advance refunded has been identified, does the advance refunding transaction require one or more levels of approval?

It would seem that with a one-time advance refunding limitation, the federal interest regarding selection of bonds to be advance refunded and the local approval process is rather limited. Questions like the two I just highlighted -- strike State and local governments as an "overreach" – which adds fatigue, delay and frustration to the questionnaire response process.

Further on the topic of post-issuance compliance, a new ACT Report was released in June of this year which focuses on the role of conduit issuers and borrowers.

If you have not yet had a chance to review the ACT Report, I think it's a worthwhile read. Given the fact that the focus on post-issuance compliance is here to stay, the ACT Report illuminates the responsibilities that are often shared between the conduit issuer and the conduit borrower.

Beyond the observations made in the ACT Report, I believe that there remain a wide range of issues to grapple with embedded within the issuer/conduit borrower relationship which include the following –

- What post-issuance policies should the issuer have in place and how directly should they focus on the capacity of the borrower to properly address a range of compliance matters – such as the final allocation and accounting of bond proceeds, tracking use, tracking cost of issuance and rebate;
- Should the issuer require the borrower to adopt written post-issuance procedures and also demonstrate some level of “tax competency” in order to be eligible to borrow on a tax-exempt basis?
- In the case of Section 501(c)(3) bonds, should the issuer ask to get a copy of the borrower's Schedule K each year - yes or no?; if they do get a copy, what responsibilities might be assumed in terms of review and follow-up.

While there are no simple answers to these questions – and the answers will differ depending on the nature of the issuer, there are a range of mutual and divergent interests which must be balanced in this relationship of necessity.

III. IRS Guidance

On the IRS published guidance front, there has been little activity this year – but there are a number of items worth commenting on ---

a. Changes to the VCAP Program

We all know that over that over the life of a bond issue actions may be taken with respect to bond financed property - property is sold, leased, privatized -- sometimes without an appreciation that such actions may jeopardize the tax-exempt status of bonds. The implementation of the IRS VCAP Program several year ago was a very positive development for addressing such matters.

On August 5 of this year, the IRS published changes to the Internal Revenue Manual regarding the administration of the VCAP program –

Briefly, here are some of the highlights –

1. The VCAP program is now available for direct pay bonds – a welcome development.
2. Until specific remedial action provisions are provided, issuers may apply the change in use rules to Build America Bonds – another welcome development.

3. The VCAP procedures now cover a violation involving the disposition of bond financed property by a Section 501(c)(3) organization. This is very helpful and hopefully, this provision can be added to the Change in Use regulations.
4. The VCAP procedures now addresses instances in which an issuer purchases its own bonds causing a retirement--largely following the format in IRS Announcement 2011-19.
5. The VCAP procedures now cover private activity violations for Build America Bonds. Under the procedures, the issuer pays a percentage of the "credit maintenance amount" with respect to the nonqualified bonds. The "credit maintenance amount" is essentially the amount of the federal subsidy – for this purpose, the subsidy is quantified and curtailed with respect to the nonqualified bonds. That is a good mechanic and an elegant solution.

One Final Observation Regarding Changes to the VCAP Program

Generally, under the revised VCAP procedures, the amount of the penalty is measured from the date of the violation. However, the IRM provides that in the event that the issuer has “written post-issuance policies”, penalties are more lenient and generally measured from the earlier of -- the date the issuer discovered or should have discovered the violation.

The passage regarding written policies now embodied in the IRM is yet another beachhead established by the IRS regarding written procedures and is indicative of the

strong policy push by the IRS to have issuers adopt such policies – rendering both a carrot and a stick.

b. Solid Waste Regulations

On August 18 of this year, the IRS released final regulations for determining whether a facility is a “solid waste facility”. In general, the final regulations retain the overall approach of the proposed regulations which were published in September 2009.

I have a number of comments on the Regulations -

1. Importantly, the final regulations do away with the "no-value" test. In the real world, the no value test was difficult to apply (especially in the case of waste recycling facilities), and became very controversial in the IRS bond audit process.

2. The final regulations make it clear that solid waste includes waste materials from governmental operations. Under the proposed regulations there was a concern that waste might be precluded if it was not generated from a commercial venue. The final regulations also clarify that a material is solid -- if it is solid at ambient temperature and pressure.

3. As under the proposed regulations, the final regulations provide that material is not waste unless the producer "reasonably expects" the material to be introduced into the “disposal process” within a reasonable time after its production. This standard could

raise questions regarding the reasonableness of an issuers expectations if there is a significant delay between production and the beginning of the disposal process.

c. IRS PLR Regarding Multi-Modal Build America Bonds

Although not yet officially published by the IRS, there is a recent private letter ruling that has been released by the issuer and within the public domain involving a holding by the IRS that a multi-mode Build America Bond will not be "re-issued" in a situation in which the issuer exercises its "option" to change interest rate modes and upon such action the holders are obligated to put the bonds to the remarketing agent.

As you know, the reissuance regulations under Section 1001 expressly provide that such regulations do not apply to tax-exempt qualified tender bonds and that the rules of Notice 88-130 otherwise govern. It was historically thought that the industry needed a carve out within the 1001 regulations for qualified tender bonds, given the concern that a put by the holder in connection with a mode change might be viewed as a bilateral option. The issuer in this ruling could not avail itself of Notice 88-130 given that BABs are taxable bonds.

In the ruling, the IRS looked at the 1001 Regulations and determined that the issuer's "option" to change interest rates was unilateral, because the holders were required under the terms of the documents to put the bonds upon such change. Hence, the combination of mode change and put did not constitute a "modification" of the debt instrument.

This is a significant ruling --- the holding here under Section 1001 that the issuers option is "unilateral" -- would appear to make Notice 88-130 obsolete.

This holding appears to be consistent with the general policy in Notices 2008-41 and 2008-88 -- in moving variable rate tax-exempt bonds closer to the Section 1001 universe. If I am correct in my analysis, IRS folks are now off the hook to publish regulations they promised shortly after the release of Notice 88-130 so long ago.

IV. Closing.

In closing, looming fiscal and budgetary challenges may impact the federal tax treatment of State and local bonds through the process of tax reform. Tax reform will dictate whether the tax-exemption is eliminated, whether it is scaled back, whether we move to a two-tier system or whether we continue with the status quo. As public finance professionals involved on a daily basis with State and local government officials -- we fulfill our responsibilities by keeping our clients informed as to current debate in Washington regarding proposed changes to the way public finance transactions may be impacted and whether State and local governments will be afforded the tools they need to make public investments.

Given the nature of the debate, the Board of Directors of NABL deserves credit for revamping the NABL brand in Washington and raising its profile to enable NABL to trade on its currency -- as an organization dedicated to providing leadership in the field of public finance.

Thank you again for your time and attention.