July 17, 2000

CC:DOM:CORP:R (REG-105565-99)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue
Washington, DC 20044

Re: Comments on Proposed Rulemaking (REG-105565-99)
Arbitrage and Related Restrictions Applicable to
Tax-Exempt Bonds Issued by State and Local Governments

Ladies and Gentlemen:

Attached hereto are comments of the General Tax Matters Committee of the National Association of Bond Lawyers on a notice of Proposed Rulemaking (REG-105565-99), Arbitrage and Related Restrictions Applicable to Tax-Exempt Bonds Issued by State and Local Governments, RIN 1545-AX22, published in the Federal Register on August 27, 1999. We appreciate your consideration of these comments and we would be pleased to make ourselves available to discuss them with you and other representatives of the IRS should you want to engage in such a discussion.

If you have any questions or require any other materials or information, I may be reached at (415) 773-5449.

Sincerely,

Charles Cardall
Chair, General Tax Matters Committee

NATIONAL ASSOCIATION OF BOND LAWYERS

COMMENTS ON PROPOSED ARBITRAGE REGULATIONS

These comments were prepared by members of the General Tax Matters Committee of the National Association of Bond Lawyers. Primary responsibility was taken by Howard J. Eichenbaum. Members of the committee who have contributed to these comments include Charles Cardall, Jeffrey McHugh, Mitchell Rapaport, David Walton, Ramiro Carbonell, Dennis Cohen, William H. Conner, Marc Feller, Irving G. Finkel, Elizabeth Youse Goetz, Jeremy A. Spector, and Arthur Zatz.

Dated: July 17, 2000

NATIONAL ASSOCIATION OF BOND LAWYERS

COMMENTS ON PROPOSED REGULATIONS

The following represent comments prepared by members of the General Tax Matters Committee (the "Committee") of the National Association of Bond Lawyers ("NABL"). These comments were prepared by the Committee in accordance with NABL's purposes. While not all members of the Committee necessarily concur in each of these comments, the comments represent the consensus of the participants. Reference herein to the term "we" or "the Committee" is to the participants identified on the cover page. In addition, certain members of the Board of Directors of NABL have reviewed the comments. We would welcome the opportunity to discuss the comments set forth below with representatives of the Department of the Treasury and the Internal Revenue Service and to answer any questions that these comments may raise.

NABL was incorporated as an Illinois nonprofit corporation on February 5, 1979, for the purposes of educating its members and others in the law relating to state and municipal bonds and other obligations, providing a forum for the exchange of ideas as to law and practice, improving the state of the art in the field, providing advice and comment at the federal, state and local levels with respect to legislation, regulations, rulings and other actions, or proposals therefor, affecting state and municipal obligations, and providing advice and comment with regard to state and municipal obligations in proceedings before courts and administrative bodies through briefs and memoranda as a friend of the court or agency. NABL currently has approximately 3,000 members.

On August 27, 1999, the Internal Revenue Service (the "Service") issued proposed regulations (the "Proposed Regulations") amending Treasury Regulation Section 1.148-5(e). The Proposed Regulations provide a safe harbor for the amount of brokers' commissions and similar fees charged in connection with the acquisition of guaranteed investment contracts ("GICs") and investments for yield restricted defeasance escrows that will be characterized as qualified administrative costs ("QACs") for purposes of computing the yield on investments under Section of 148 of the Internal Revenue Code of 1986 (the "Code").

At the public hearing conducted on December 14, 1999, with respect to the Proposed Regulations, various parties opposed adoption of the Proposed Regulations. At a recent ABA meeting, comments were made by representatives of the Service to the effect that the Service is considering simply withdrawing the Proposed Regulations in the absence of any comments supporting the Proposed Regulations. Although there may be legitimate criticism of certain aspects of the safe harbor proposed, we strongly urge the Service not to abandon the idea of providing a safe harbor. We encourage the Service to explore adjustments to the safe harbor to address the comments received but to retain and implement a safe harbor along the lines of the Proposed Regulations.

NABL and the Committee fully support the adoption of, indeed the need for, a safe harbor for QACs in the context of GICs and yield restricted escrows. Our failure to submit comments prior to the public hearing indicates NABL's and the Committee's general satisfaction with the Proposed Regulations and their basic approach and the absence of any major glitches in the Proposed Regulations that need fixing. In short, the Service did a good job in crafting the Proposed Regulations and, with appropriate modifications, they should be finalized promptly.

A SAFE HARBOR FOR GICS IS NEEDED

Treas. Reg. Sec. 1.148-5(e)(2)(iii) provides that in the case of a GIC, a broker's commission is treated as a QAC to the extent the present value of the fee "does not exceed the lesser of a reasonable amount . . . or the present value of annual payments equal to .05 percent of the weighted average amount reasonably expected to be invested each year of the term of the contract." A safe harbor was adopted in December, 1998, providing that a bidding agent fee for investments for a yield restricted defeasance escrow is a QAC only if the fee is comparable to a fee that would be charged for a reasonably comparable investment acquired with a source of funds other than gross proceeds of tax-exempt bonds, and is reasonable. A broker's fee is deemed to be comparable to a fee that would be charged for a comparable investment, and to be reasonable, if the fee does not exceed the lesser of $10,000 or .1% of the initial principal amount of investments deposited in the yield restricted defeasance escrow. The current regulations provide little practical guidance upon which an issuer of tax-exempt bonds can rely to determine that a bidding agent fee for a GIC is a reasonable amount. The comparable fee rule set forth in Treas. Reg. Sec. 1.148-5(e)(2)(i) provides only a starting point for the analysis.

We do not agree with the proposition, set forth by certain commentators at the public hearing, that the existing rules work well. We believe they need improvement primarily in the form of a safe harbor for determining a reasonable amount. The current GIC bidding rules often put the burden on the issuer and, as a practical matter, bond counsel, to establish that a broker's fee for a GIC is reasonable and therefore recoverable in yield. Most bond lawyers and issuers do not have the necessary expertise in evaluating the proper, market based, reasonable amount of bidding agent fees to make that determination. Furthermore, to the extent a fee is recoverable in yield, there may be some lack of incentive for issuers to expend the time and resources necessary to establish that such a fee is arms' length. A safe harbor would provide issuers and bond counsel a much needed level of certainty that a broker's fee of x% or $y can be recovered as a QAC.

Since many practitioners interpret the existing GIC bidding rules to provide a 5 basis point cap on broker's fees, some commentators with respect to the Proposed Regulations argued the proposed safe harbor would also effectively serve as a cap on the amount of fees that can be charged. We agree that the Proposed Regulations if adopted could have such an effect in a large percentage of cases; however, the language of the Proposed Regulations clearly allows for cases where higher fees might be recoverable. After all, that is the nature of a safe harbor provision. Furthermore, the establishment of a safe harbor would not prohibit payment of a brokers' fee at a level above the safe harbor even if the issuer or bond counsel is unable to determine that such excess is reasonable under the facts in a given case. It would simply limit the amount of the fee that could properly be included in the computation of the yield of the investment. By providing a safe harbor, the Service will effectively (and properly) shift the burden to brokers to justify a fee above the safe harbor as reasonable.

Sometimes the role of bidding agent can be bid out, thus providing a market based test of the reasonableness of the fee; however, in many cases, this is not practical. Sometimes a financial advisor is willing to certify that a fee is reasonable. In many (maybe most) cases, however, there is no financial advisor or the financial advisor is not willing to provide such certification. In any case, relying on such certifications can be problematic, as the yield burning controversy has shown. An example in which a GIC broker fee in excess of the safe harbor is determined to be reasonable would be helpful.

We understand that there may be disagreement on the level of the safe harbor and believe some adjustments to the Proposed Regulations may be needed to accommodate small and large transactions, the number of investments, or certain types of more complicated investments. Brokering the investment of a large principal amount may not necessarily justify charging a proportionately larger fee. Similarly, brokering the investment of a very small principal amount usually does not require a proportionately smaller amount of work for the broker. In our view, a minimum fee for smaller transactions is reasonable. Perhaps a limitation that would provide $x+y basis points up to a dollar limit could work. Further, longer term investments, and debt service reserve fund investments in particular, are more complicated to acquire than short term investments. Rather than creating more safe harbors, perhaps this circumstance is best dealt with by an example that sets forth factors to be considered when exceeding the safe harbor and an actual fee amount that is a QAC even though it exceeds the safe harbor. We believe that the Service should consider adjusting the safe harbor in these respects.

Technical Comments

The definition of computational base examines the amounts that the issuer expects to be deposited into a GIC "as of the issue date" and "over the term of the contract." This is stated differently in the preamble. What if no GICs are expected at <u>issue date</u>, but only at a later time, either for a debt service reserve fund, or a sinking fund? The definition suggest that since no GICs were originally expected "on the issue date," no bidding agent fees are QACs. This seems an unwarranted, and, we suspect, an unintended result. The issue date reference should be dropped or should refer to the date the GIC is entered into or bid out.

Our reading of the Proposed Regulations indicates that the portion of the fee which is within the safe harbor amount is always treated as a QAC. If the broker fee paid exceeds the safe harbor limit, and the excess is determined not to be a QAC and recoverable in yield, is such excess treated as a cost of issuance or something else? What if the amount paid is still determined to be a reasonable amount? We assume in such a case that the excess is treated as a QAC (only). These questions could be important if the issue is subject to the 2% limit on costs of issuance set forth in Code § 147(g).

The Proposed Regulations cover (a) guaranteed investment contracts (regardless of the fund in which such contracts are held) and (b) investments purchased for yield restricted defeasance escrows. We cannot see any policy reason for not extending these rules to all investments purchased with or otherwise allocated to the proceeds of tax-exempt obligations, regardless of the fund in which the investments are held, and regardless of whether such investments are subject to yield restrictions or rebate requirements. We urge the Service to expand the scope of the rules accordingly.

There are some examples/explanations in the preamble that would be useful to place into the language of the regulation. For example, the preamble refers to a debt service fund GIC with helpful explanation of the phrase "the amount reasonably expected to be deposited" being all periodic deposits reasonably expected to be made pursuant to the terms of the contract.

The term - yield restricted defeasance escrow is used in both the existing and the Proposed Regulations. The words "defeasance escrow" should be removed and replaced by the word "fund." QAC safe harbors should extend to any fund that is yield restricted (or as discussed above, non-yield restricted funds), without regard to whether it is part of a defeasance escrow, which is not a defined term in the Treasury Regulations.

The $75,000 overall, per issue cap in the Proposed Regulations on the amount that can be treated as a QAC raises a question as to how the rule applies in cases where a restructuring of investments occurs at a later date, and the cap has already been substantially or completely utilized by an earlier bidding process. For example, assume on the date of issue that sale proceeds are deposited into a construction fund and a debt service reserve fund, and replacement proceeds will be deposited into the debt service fund. At closing, the issuer acquires three GICs, subject to the bidding rules, one for each such fund. Assume further that the overall cap is used up by the bidding process for such GICs. What is the appropriate treatment, if, several years later, a new debt service reserve fund GIC is acquired, or if amounts in the reserve fund are transferred to a refunding escrow (or a sinking fund) and used to purchase investments subject to the limitation on QACs? What if new refunding proceeds are deposited into the escrow with the reserve fund monies? Is only a portion of the bidding agent fees for the escrow investments treated as a QAC? The application of the cap to these scenarios should be clarified. We suggest it is appropriate to allow an additional amount of cap in such situations (at least if enough time has elapsed, or if the subsequent transactions are clearly independent of the transactions which initially utilized the overall cap). If a particular fee otherwise is reasonable and is unrelated to any fees paid for other investments or other services provided, the disallowance of the fee as a QAC based on an overall, per issue cap seems unfair.

Effective Date

The safe harbor should be effective for transactions consummated after the adoption of the final regulations, regardless of the issue date of the bonds (assuming any bidding agent fee is recoverable for investments allocated to the issue - i.e, bonds subject to the 1993 arbitrage and later regulations), so that issuers and counsel are not left with the old unclear standards. There is precedent for this under Rev. Proc. 97-13. However, if the Service does so, it should indicate whether any prior bidding agent fees count against the overall cap on bidding agent fees.

We applaud the efforts of the IRS in drafting the Proposed Regulations and ask that they be finalized in substantially their proposed form.