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RE: Related Party Acquisitions of Build America Bonds

Gentlemen:

We are attaching a paper, prepared by the Tax Law Committee of the National Association of Bond Lawyers under the leadership of Michela Daliana, Hawkins Delafield & Wood LLP, on related party acquisitions of Build America Bonds. As described in greater detail below, NABL concludes that any abuses that may potentially arise as a result of related party acquisitions of BABs can be fully addressed under existing federal tax law and without upsetting longstanding federal tax authorities under Sections 103 and 141 through 150.

Please do not hesitate to contact Michela Daliana at (212) 820-9631, if you have any further questions on this topic.

Sincerely,

John M. McNally
President

RELATED PARTY ACQUISITIONS OF BUILD AMERICA BONDS
June 2011

Introduction.

Issuers of build America bonds and recovery zone economic development bonds (hereinafter "BABs")[1] include States and political subdivisions, as well as entities issuing on behalf of States and political subdivisions. Many of these issuers exercise some degree of control over, or are otherwise related to, legally separate and distinct governmental entities. It is our understanding that the Internal Revenue Service and Treasury Department are considering the issue of whether BABs acquired by such "related"[2] entities continue to qualify as BABs as a result of a merger of interest between the borrower and the lender. As described in greater detail below, we believe that the applicable legal standard for determining whether a BAB is deemed extinguished (or never issued) as a result of a related party acquisition is, at best, unclear. Moreover, application of an "integral part" standard for these purposes could, depending on how the numerous inconsistent and contradictory authorities in this area are applied, lead to significant unintended consequences. Ultimately, we believe that any abuses that may potentially arise as a result of related party acquisitions of BABs can be fully addressed under existing federal tax law and without upsetting longstanding federal tax authorities under Sections 103 and 141 through 150.

Debt Among Related Entities.

Under general federal tax principles, bona fide debt between related but distinct entities is respected. "The fact that the debtor and creditor are related parties does not preclude the existence of a bona fide debt." Calumet Industries, Inc. v. Comm'r, 95 T.C. 257, 286 (1990).[3] Transactions between related parties may be scrutinized under federal tax law to ensure that what purports to be debt represents bona fide debt,[4] as opposed to a capital contribution, gift or other transfer; bona fide

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[1] The federal tax rules applicable to build America bonds are set forth in Sections 54AA, 103, 141, 148-150 and 6431 of the Internal Revenue Code of 1986 (the "Code"). Recovery zone economic development bonds are also subject to Code Sections 1400U-1 and 1400U-2. Unless otherwise indicated, all section references are to the Code.

[2] The terms "related parties" and "related entities" are used herein in a general sense to refer to entities with some degree of common control or affiliation. As described herein, the standards for determining whether parties are related are numerous and conflicting.

[3] In Calumet, the Tax Court allowed a parent corporation a bad debt deduction under Section 166 for loans to a subsidiary that had become worthless.

[4] The discussion set forth herein assumes that BABs are, but for the merger of interest issue described herein, bona fide debt. Factors to be considered in evaluating whether an obligation represents bona fide debt include: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payments; (5) participation in

debt between related parties, however, is generally not treated any differently than debt between unrelated parties.[5] For example, the obligor on the debt is entitled to deductions for the interest paid on the debt,[6] and the holder of the debt will recognize interest income.[7] If the debt becomes worthless, the related creditor may be entitled to a bad debt loss.[8]

The general federal tax principle that related party debt is respected can be found throughout the Code and Treasury Regulations (the "Regulations"). Each of the following provisions of the Code and Regulations is premised on the assumption that one entity can lend to or borrow from a related entity and that the loan will be treated as an obligation for federal income tax purposes:

1. Section 1.1502-13(g) of the Regulations addresses debt obligations between members of a consolidated group. Section 1.1502-13(g)(1) of the Regulations defines "obligation of a member" as "a debt or security of a member," and "debt of a member" as "any obligation of the member constituting indebtedness under general principles of Federal income tax law . . . ." The Regulations explicitly provide that an "intercompany obligation," defined as "an obligation between members, but only for the period during which both parties are members," is to be recognized as valid debt for Federal income tax purposes.

2. Section 108(e)(4) provides that, "for purposes of determining income of the debtor from the discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in Section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor." Section 108 goes on to direct the Treasury to provide for appropriate adjustments in the treatment of any subsequent transactions, including the indebtedness. No such adjustments would be necessary if the debt were treated as extinguished by the acquisition. Instead, the Regulations

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management as a result of the advances; (6) the status of the advances in relation to regular corporate creditors; (7) the intent of the parties; (8) the identity of interest between creditor and stockholder; (9) "thinness" of the borrower's capital structure in relation to debt; (10) the ability of the borrower to obtain credit from outside sources; (11) the use to which advances were put; (12) the failure of debtor to repay; and (13) the risk involved in making advances. No single factor is determinative. See Dixie Dairies Corp. v. Comm'r, 74 T.C. 476, 493-94 (1980).

[5] See Estate of Mixon v. U.S., 464 F.2d 394 (5th Cir. 1972) ("[t]he real issue for tax purposes has long been held to be the extent to which the transaction complies with arm's length standards and normal business practice"); Litton Business Systems Inc. v. Comm'r, 61 T.C. 367 (1973) ("[t]he ultimate question is was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship").

[6] Comm'r v. Union Motors, Inc., 119 F.2d 93 (9th Cir. 1941) (interest deduction allowed for loan between corporations owned by the same shareholders); Malone & Hyde, Inc., 49 T.C. 575 (1968) (interest deduction allowed on loan between corporation and wholly-owned subsidiary).

[7] Greer-Robbins Co. v. Comm'r, 119 F.2d 92 (9th Cir. 1941); see also Hardman v. U.S., 827 F.2d 1409 (9th Cir. 1987) (addressing treatment of payment in satisfaction of full debt).

[8] American Processing & Sales Co. v. U.S., 371 F.2d 842 (Ct. Cl. 1967) (bad debt loss allowed for advance made to related corporation).

promulgated under Section 108 establish a detailed regime under which acquired debt is treated as reissued in the hands of the related holder.

3. Revenue Ruling 2003-125[9] addresses the situation where an election is made to change the federal tax classification of an entity from a corporation to a disregarded entity under Section 301.7701-3 of the Regulations, and whether the shareholder of the erstwhile corporation is allowed a worthless security deduction under Section 165(g)(3). The revenue ruling concludes that where the fair market value of the assets of the corporation does not exceed the sum of its liabilities (including the debt owed to the parent) immediately prior to its change in status, (i) the stock of the corporation is worthless, (ii) the parent is allowed a worthless security deduction under Section 165(g)(3), and (iii) the parent may be entitled to a deduction for worthless debt under Section 166.

4. Section 1.482-2(a) of the Regulations addresses the situation where one member of a group of controlled entities makes a loan to another member and does not charge adequate interest, permitting the Internal Revenue Service to make appropriate allocations to reflect an arm's length rate of interest.

5. Section 163(j) denies a deduction for interest paid to a related person if no tax is imposed with respect to such interest in the hands of the holder.

We are unaware of any authorities under Sections 103 or 141 through 150 that would alter the general federal tax principle that bona fide debt among related but discrete entities is to be respected.[10] To the contrary, there is ample authority indicating that this general federal tax principle applies. For example, Section 1.150-1(b) of the Regulations defines the term "obligation" as any "valid evidence of indebtedness under general Federal tax principles."[11] The only provision we are aware of in Sections 103 and 141 through 150 and the Regulations promulgated thereunder that does not recognize transactions between related parties is found in Section 1.148-6(d)(7) of the Regulations, which provides that the payment of gross proceeds of an issue to a related party does not constitute an expenditure of those gross proceeds. We find the lack of a parallel rule for related party borrowings particularly persuasive evidence that the general federal tax principles governing related party borrowings are to apply. More broadly, Section 1.148-6(d)(7) of the Regulations supports the position that transactions between related parties are respected under federal tax law absent a specific rule to the contrary. Otherwise, Section 1.148-6(d)(7) of the Regulations is

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[9] 2003-52 I.R.B. 1243.

[10] Although BABs are federally taxable obligations, BABs must, but for the application of Section 54AA, qualify as tax-exempt obligations under Section 103.

[11] Notice 2008-41, 2008-15 I.R.B. 742, states that "for purposes of determining whether a bond is purchased or otherwise acquired by or on behalf of a governmental issuer, except as otherwise expressly provided in § 3.2(3) and § 4 of this Notice, a bond is treated as purchased or otherwise acquired by or on behalf of a person if the bond is purchased or otherwise acquired <u>by that person</u> in a manner that liquidates the bondholder's investment." (emphasis supplied).

superfluous. As evidenced by this provision, the Treasury Department is aware of, and capable of providing special rules to alter the general federal tax principles associated with, related party transactions.

Had it chosen to do so, Congress certainly could have limited the ability of issuers to claim a direct-pay subsidy for BABs acquired by related parties. The "substantial user" limitation set forth in Section 147(a) is an example of a situation in which Congress has utilized a related party concept to limit the benefit of federally-subsidized debt. Section 147(a) denies tax-exempt treatment for interest on certain qualified private activity bonds during the period that such bonds are held by a person who is a substantial user of the financed facilities or a "related person" of such a substantial user. Section 147(a)(2) defines the various relationships that cause two or more persons or entities to be treated as related. There is no statutory parallel to the substantial user rule applicable to related party acquisitions of BABs.

In Revenue Ruling 79-79[12] ("Rev. Rul. 79-79"), the Internal Revenue Service addressed the issue of when bonds delivered by New York City to city and state employee pension funds under the provisions of the New York City Loan Guarantee Act of 1978 (the "NYC Loan Guarantee Act")[13] were deemed to be issued under Section 103(c) of the Internal Revenue Code of 1954. Section 102(a) of the NYC Loan Guarantee Act provided that the Secretary of the Treasury could, upon written request of New York City and the Governor of the State of New York, guarantee the payment of principal and interest on New York City debt. This guarantee, however, was only effective with respect to debt that was delivered to New York City or State of New York employee pension funds, or the pension funds of any agency of New York City or the State of New York. Moreover, the guarantee terminated whenever such indebtedness was sold or otherwise disposed of by the fund. Section 103(f) of the Internal Revenue Code of 1954, effective at the time of publication of Rev. Rul. 79-79, provided that interest on any obligation guaranteed under the aforementioned provision of the NYC Loan Guarantee Act would not be tax-exempt for the period of time the guarantee was in effect. Although interest on the guaranteed obligations was not tax-exempt, there remained a question of whether, for arbitrage purposes, the guaranteed bonds were deemed issued on the date they were delivered to the employee pension funds or the date they were disposed of by such funds. Ultimately, the Internal Revenue Service concluded that "the proper date for determining whether the City of New York bonds are arbitrage bonds within the meaning of section 103(c) of the Code is the date the bonds are issued." Thus, notwithstanding the fact that the bonds were delivered to a related party, the Internal Revenue Service concluded that the bonds were issued when delivered to the employee pension funds. Although Rev. Rul. 79-79 was an arbitrage bond ruling, its holding is based on the conclusion that, notwithstanding New York City's relationship with its pension fund, the bonds represented bona fide debt while held by the pension fund and the bonds were in fact issued.

"Integral Part".

We understand that the Internal Revenue Service and Treasury Department are evaluating whether an entity that is an "integral part" of a State or political subdivision should be disregarded and considered part of such State or political subdivision, at least for purposes of determining if

[12] 1979-1 C.B. 74.
[13] Pub. L. No. 95-339, 92 Stat 460 (1978).

BABs have been issued or are outstanding. If such a "single entity" conclusion applies for BAB extinguishment purposes, it would also seem to apply for tax-exempt bond purposes and presumably for all other federal tax purposes. We do not believe as a general matter that all integral part entities should be treated as a single entity for purposes of addressing BABs extinguishment issues. This approach is not mandated anywhere in the Code and would not further any significant Federal tax policy. The application of an integral part standard would be nearly impossible to administer in light of ambiguity in the law as to what constitutes an integral part and the facts and circumstances analysis that is required for such a determination. Moreover, collapsing an integral part entity into the political subdivision could result in unintended consequences under Section 103 and 141 through 150.

An entity that does not qualify as a State or political subdivision for federal income tax purposes may nevertheless be treated as a governmental entity if it qualifies as an integral part, a Section 115 entity or an instrumentality. Determining whether an entity fits within one or more of these categories is dependent upon a facts and circumstances analysis and involves the application of legal standards that have become muddled. Unfortunately, the check-the-box regulations do nothing to clarify matters. Section 301.7701-1(a)(3) of the Regulations provides, in part, that "[a]n entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State." The quoted example appears to contemplate that an organization that (1) is "wholly owned" by a State,[14] and (2) constitutes an integral part of the State will not be recognized as a separate entity for federal tax purposes. Section 301.7701-2(b)(6) of the Regulations, however, treats "[a] business entity wholly owned by a State or any political subdivision thereof" as a separate corporation that must establish its own federal tax status. As one commenter has stated, these regulations "like the rulings, take the less than helpful position that a body corporate and politic is *per se* separate from the political subdivision that owns it, unless it isn't. The regulations do nothing to resolve the question of whether separateness is a matter of organizational form or governmental control."[15]

In any event, what it means to be an integral part is poorly defined and does not provide an administrable rule. Moreover, the standards employed by the Internal Revenue Service in this area are "amorphous and shifting."[16] Indeed, it is our understanding that the Internal Revenue Service has taken the position that, at least in part due to the uncertainty as to the proper legal standard to be applied, it will not entertain private letter ruling requests from entities seeking integral part recognition. An examination of the rulings under Section 103 involving requests by entities related to, or affiliated with, a State or political subdivision for recognition as a qualified issuer of tax-exempt bonds demonstrates that integral part status has traditionally not been sought, because governmental entities can more easily qualify as instrumentalities, Section 115 organizations or constituted authorities. The rulings addressing the status of entities in these other categories imply that the subject entities are respected as separate entities for federal tax purposes. Perhaps the best

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[14] We are unaware of any federal tax law authority that addresses what it means for a governmental entity to be "wholly owned" by a State or political subdivision.
[15] Ellen P. Aprill, *The Integral, the Essential and the Instrumental: Federal Income Tax Treatment of Governmental Affairs*, 23 J. Corp. L. 803 (1998).
[16] Id.

examples of this are found in revenue rulings and private letter rulings for constituted authorities[17] and "63-20" corporations.[18] These rulings implicitly assume that the entity in question is not an integral part of a State or political subdivision. Otherwise, the obligation would be treated as if it were issued by a State or political subdivision. A close review of the attributes of the entities involved in these rulings, however, suggests that many (perhaps most) of the entities could qualify as integral part entities.

The application of various statutory and regulatory provisions applicable to tax-exempt bonds are called into question unless integral part entities enjoy separate federal tax status. Consider the following:

1. Section 1.150-1(e)(3) of the Regulations sets forth a safe harbor for determining when two governmental entities are not part of the same controlled group and therefore are not related persons. The safe harbor is satisfied if the subordinate entity has a substantial amount of all three sovereign powers. However, there are political subdivisions with all three sovereign powers that, under a broad integral part analysis, could be disregarded. Effectively, the entities would be treated as a single entity under an integral part analysis, but as unrelated persons under Section 1.150-1(e)(3) of the Regulations.

2. Section 1.150-1(d)(2)(ii) of the Regulations provides that an issue is not a refunding issue to the extent the obligor of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. For these purposes, the obligor of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower. If integral part entities are collapsed into a single entity, it would be unclear how to apply this change in obligor rule.

3. Section 149(f)(7)(A)(ii), relating to pool bonds, states that a loan of tax-exempt bond proceeds will be respected even if the loan is from an issuer to "an agency of the issuer" so long as "such agency is a political subdivision or instrumentality of the issuer." Query how to apply this statutory provision if, for example, a State agency that also qualifies as a political subdivision is collapsed into the State.

4. Section 265(b)(3)(E)(ii) provides that subordinate political subdivisions each receive their own separate small issuer limitation. Many of the private letter rulings in this area involve situations where the subordinate political subdivision would appear to be an integral part of another entity.[19]

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[17] See, e.g., PLR 200936012, PLR 200911003 and PLR 200718027. There are many others.

[18] See, e.g., PLR 8903085. We note that, in the event that integral part entities are not recognized as legally distinct organizations for federal tax purposes, the application of Revenue Procedure 82-26, 1982-1 C.B. 476, is called into question. For example, most "Type 2" 63-20 corporations are governed exclusively by the State or political subdivision on whose behalf the corporation issues bonds. If these corporations are ignored for federal tax purposes, the corporations may avoid Revenue Procedure 82-26 entirely, meaning, among other things, the bonds issued by most "Type 2" 63-20 corporations would be eligible to be advance refunded.

[19] See., e.g., PLR 8902018 and PLR 8851018.

Pension Funds.

It is our understanding that the Internal Revenue Service and Treasury Department are concerned about situations involving the acquisition of BABs issued by a State or political subdivision by one or more pension funds to which such State or political subdivision is a contributor. In particular, we understand that a question has arisen as to whether such BABs are outstanding if they are purchased by the trust fund for a pension plan to which the issuer is a contributor. This question is predicated on the concern that a trust fund for a pension plan established and maintained by the issuer may be an integral part of the issuer. The logic behind this inquiry would be that, if the plan and the trust are an integral part of the issuer, the government issuing the obligations may be deemed not to have issued the obligations but rather to have merely shifted their purchase price from one pocket, the pension plan's trust, to another, its own accounts. A similar question may arise on a post-issuance or secondary market purchase of BABs by the trust of a pension plan. If that pension plan and trust are an integral part of the issuer, the ownership of the obligations of that government by its trust will arguably result in their extinguishment. We note that, consistent with the observations we have made above, this logic would seem to extend to the acquisition of tax-exempt obligations as well as BABs.

Given the enormous variety of ways the relationships between governments and their pension plans have been structured, an integral part analysis of a pension fund would involve an intensive analysis of the facts and circumstances surrounding the relationship of such examined pension fund to its governmental contributor(s). Such an analysis would require a determination as to whether the purchaser is a trust for a governmental pension plan, whether the plan was established and is being maintained by the governmental issuer of the obligations, whether the plan is more loosely affiliated with the issuer (as when the plan serves multiple governmental entities), and, ultimately, based on the particular facts and circumstances, whether the pension plan is an integral part of that issuer.

The only statutory guidance for determining whether a pension plan is a governmental plan is found in Section 414(d). The crucial language in that section defines a governmental plan for purposes of Section 401 as a "plan established and maintained for its employees . . . by the government of any State or political subdivision thereof, or any agency or instrumentality of the foregoing." Thus, the first step will be to determine whether the pension plan whose trust bought the obligations in question is a governmental plan. If it is a governmental pension plan, the Employee Retirement Income Security Act of 1974 (ERISA) specifically does not apply. Indeed, there is no federal law like ERISA imposing fiduciary responsibilities on governmental pension plans and their trusts. As a result, questions have arisen as to whether a given pension plan is in fact a governmental plan.

Some questions are based on whether the entity establishing the plan is in fact a political subdivision, an agency or instrumentality of a government. Other questions arise from ambiguity as to who established or who maintains the plan, as discussed below. Perhaps as a result of the lack of statutory guidance, the Internal Revenue Service will not rule on whether a plan is a governmental plan under Section 414(d).[20]

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[20] See Rev. Proc. 2010-4, 2010-1 I.R.B. 122.

Similarly, perhaps for reasons of federal-state comity and the absence of statutory guidance, the Internal Revenue Service has been reluctant to raise issues as to discrimination in governmental pension plans or the taxability of the income of their trusts. In News Release IR 1869 (August 10, 1977), the Internal Revenue Service stated that such issues will not be raised until a review of these matters is completed, and pending completion, the Internal Revenue Service will resolve these issues in favor of the taxpayer or the governmental unit. Nothing has been forthcoming, possibly, again, because of the difficulty of providing general rules to make sense of the enormous variety of ways that governmental pension plans and trusts are structured. The lack of a common structure for governmental pension plans may be based in part on the fact that there is no benefit to a governmental entity from qualifying its pension plan under Section 414(d) as a governmental pension plan since it has no need for tax deductions for its contributions.

If the trust that purchased the obligations in question is clearly the trust of a governmental pension plan, the next question is whether that plan was established and is being maintained by the government that issued the obligations. That too may pose problems. For example, a plan may be established through a collective bargaining agreement with one or more public employee unions. A given plan may cover the employees of a number of governments, or even have been established by a private entity but now be maintained by a government. Some plans may be funded to varying degrees, or entirely, by employee contributions. All of these considerations raise the question of whether a plan is "established and maintained" by the government.

Finally, even if the plan is a governmental plan established and maintained by the government whose obligations it bought, there is still the need to determine whether the pension plan and its trust are an integral part of the governmental entity. As noted above, there is no federal law prescribing fiduciary duties or describing what the relationship between the government and the plan must be. There is not even a federal requirement that the funds held for a plan must be held in an independent trust with independent trustees. The relationship of each plan to each government is generally controlled by State and local constitutional and contract law, and the rules, regulations, policies and procedures promulgated by the State and local governments with respect to them. These provisions vary widely from jurisdiction to jurisdiction.

For that reason, it would be extremely difficult to determine whether a given plan is an integral part of a government. G.C.M. 34704 (Dec. 2, 1971) illustrates the difficulty involved in this analysis. In it, the Internal Revenue Service analyzed a State's employee retirement plan and the State's accident insurance plan, reviewing the two different State statutes under which the funds were organized and how the plans fit with the six factors to be taken into account in deciding whether an organization is a state instrumentality. Neither structure established under the two statutes fit neatly under the six factors, particularly as to their trusts. However, the Internal Revenue Service was able to conclude that the plans provided for genuine trust funds and that "[a] trust created by a State to perform state functions is a state instrumentality . . . .." This conclusion repeated a previous conclusion, in G.C.M. 34502 (May 21, 1971), wherein the Internal Revenue Service stated "that when a state organization 'is organized and operates as a trust, it must be regarded as legally separate from its governmental creator for purposes of the Internal Revenue Code.'"

We believe that, to the extent there is any existing guidance on the issue of whether a pension fund is to be treated as a single entity with its contributing State or political subdivisions, the Internal Revenue Service would have to start from the position that, if the obligations were purchased by a trust for a governmental pension plan established and maintained by the government that issued the obligations, the trust is a separate entity from the government. Those obligations would have been issued and cannot be deemed to have been extinguished by merger within the same entity. Indeed, the Internal Revenue Service has already endorsed this approach in Rev. Rul. 79-79. Conversely, if the purchasing trust is not part of a governmental pension plan established and maintained by the government that issued the obligations, there would also be no merger of interest concern at all.

Related Party Acquisitions of BABs – Addressing Abusive Transactions.

We acknowledge there is a concern that subsidy payments on BABs made to issuers could cause market participants to pursue abusive transactions, including those involving acquisitions of BABs by entities related to the issuer. It is our view that the Internal Revenue Service has the ability to address any such abusive transactions utilizing existing statutory and regulatory rules applicable to BABs.

Although we acknowledge there is a potential for abuse involving related party acquisitions of BABs, it is difficult to envision an abuse in a situation involving the typical purchase of BABs by a related party investor. In most such cases, we believe it will be clear that (1) the related party investor acquired the BABs at a fair market value price as a member of the public, (2) the issuer of the BABs was not contemplating (or even aware of) the acquisition when it structured and sold the BABs, (3) the issuer of the BABs will not receive any special benefit because of the related party investor purchase, and (4) the Internal Revenue Service will not be harmed as a result of the related party investor purchase.[21]

We believe that the typical related party acquisition of BABs, either upon initial issuance or in the secondary market, is clearly not abusive. An example of a related party acquisition scenario serves to highlight this point. Consider a situation involving the sale by an issuer of all or a portion of a BABs issuance to an affiliated pension fund. Assuming the BABs were sold at fair market value, neither the issuer nor the pension fund derives any economic benefit from the fact that the parties are affiliated. From the perspective of the issuer, the identity of the purchaser of its BABs has no impact on its interest cost or subsidy payments and it would not have sold a non-tax-advantaged instrument to the pension fund simply because of the affiliation. From the perspective of the pension fund, it could have purchased BABs from an unrelated issuer and the economics of the transaction would have been the same. Finally, there is no harm to the Internal Revenue Service because nothing about the relationship between the issuer and the pension fund has resulted in a higher level of subsidy payments than would have been payable had the BABs been sold to an

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[21] We understand there is a concern that, through the sale of BABs to a related purchaser, issuers are able to "shift money from one pocket to the other." Such a concern ignores the reality that, had the issuer not sold its BABs to the related purchaser, it would have sold the same BABs to another purchaser and the economics would, absent an abusive situation, have been identical for the issuer, the purchaser and the Internal Revenue Service.

unrelated investor. The considerations outlined above are more obviously applicable to acquisitions of BABs in the secondary market by entities related to the issuer.

The Internal Revenue Service already possesses the ability to rein in abuses stemming from related party acquisitions of BABs without upsetting longstanding principles of federal tax law under Sections 103 and 141 through 150. In the event that the Internal Revenue Service has reason to believe that an issuer sold BABs to a related pension fund at an inflated yield, thereby resulting in excess subsidy payments based on the inflated coupon, the Internal Revenue Service could address this abuse by challenging the "issue price" of the BABs under Section 1.148-1(b) of the Regulations and with substance over form arguments. For example, the Internal Revenue Service could argue that a portion of the inflated coupon to be paid to the pension fund was not, in fact, interest, but rather a contribution by the issuer to its related pension fund. Similarly, should the Internal Revenue Service have reason to believe that an affiliated entity acquired BABs as the agent of the issuer so as to permit the issuer to, in effect, escrow BABs until delivered to the secondary market, the Internal Revenue Service could utilize, among other possible options, substance over form arguments, the definition of "issue date" in Section 1.150-1(b) of the Regulations, the definition of "issue price" in Section 1.148-1(b) of the Regulations or the hedge bond rules in Section 149(g) to address the potential abuse.

Conclusion.

We are of the view that the applicable legal standard for determining whether a BAB is deemed extinguished (or never issued) as a result of a related party acquisition is, at best, unclear. Application of an integral part standard for these purposes would almost certainly lead to confusion and could result in significant unintended and unnecessary consequences, including upsetting longstanding federal tax authorities under Sections 103 and 141 through 150. While we acknowledge that there is a concern that subsidy payments on BABs made to issuers could cause market participants to pursue abusive transactions involving related entities, we believe that the Internal Revenue Service already possesses the ability to address any such abusive transactions utilizing existing statutory and regulatory rules applicable to BABs, without the need to invoke an integral part standard or adopt a new anti-abuse rule. Nonetheless, should the Internal Revenue Service or the Treasury Department issue guidance in this area, we believe that such guidance should only apply prospectively in light of the significant uncertainty surrounding these issues.

National Association of Bond Lawyers
Related Party Acquisitions of Build America Bonds Project
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