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August 31, 2011

John J. Cross, III
Associate Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Recommendation to Authorize U.S. Treasury to Create Transition Rule for Refinancings of State and Local Bonds

Dear Mr. Cross:

Please find enclosed a draft of proposed statutory language that would enable the United States Treasury Department, in appropriate cases, to create transition or “grandfather” rules to allow the refinancing, subsequent to various statutory deadlines, of state and local bonds that were issued prior to such statutory deadlines. A written explanation of this statutory language, including the merits of the Treasury Department’s having such authority, is included with this letter.

NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. We respectfully provide this submission in furtherance of that mission.

If NABL can provide further assistance, please do not hesitate to contact Penny Rostow in our Washington Office at (202) 503-3300.

Sincerely,

John M McNally

John M. McNally

Enclosures
cc: James Polfer, Internal Revenue Service

Explanation of Statutory Provision
Directing Treasury to
Provide Appropriate Refunding Transition Rules

Purpose

This proposal authorizes the Treasury, in appropriate cases, to create regulations that accord substantially the same tax advantage to state or local bonds (e.g., exclusion of interest from gross income) issued after a statutory deadline to refund outstanding state or local bonds issued prior to such statutory deadline.

Background

From time to time, Congress, through the passage of legislation signed into law, amends, adds or deletes sections of the Internal Revenue Code of 1986, as amended (the "Code"), governing the tax advantages of holding or issuing state or local bonds[1] and the requirements for achieving such advantages. The most notable advantage is the ability of a holder of a state or local bond to exclude from such holder's gross income the interest accrued and payable on such bond. Over time, other advantages of holding a state or local bond have developed, including the ability of a bondholder to avoid the disallowance of a substantial portion of such bondholder's deduction for interest expense on the portion of such bondholder's debt treated as "allocable" to the holding of state or local bonds.

More recently, the American Recovery and Reinvestment Act of 2009 ("ARRA") introduced an array of tax incentives designed to "jump-start" the United States economy in the wake of the financial crisis, including most notably the introduction of "build America bonds" ("BABs").[2] ARRA also increased threefold the limit on the amount of "qualified tax-exempt obligations"[3] that could be issued, and liberalized the limit's aggregation rules, permitting the issuance of conduit bonds for 501(c)(3) organizations without aggregation with other bond issues of the conduit issuer. ARRA also created an alternative minimum tax ("AMT") "holiday" for two years (2009-2010), allowing the interest on private activity bonds (other than qualified

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[1]The term "state and local bonds," as used herein, includes any valid indebtedness for federal income tax purposes that is issued by (or on behalf of) a state or local governmental unit within the meaning of section 1.103-1 of the Treasury Regulations.

[2]Though BABs in the first instance were conceived as tax credit bonds, the subset of BABs providing for a direct subsidy payment by the federal government to the issuer of BABs, equal to 35% of the interest on the BABs, became the primary, if not exclusive, way in which BABs were issued. Therefore, for purposes of this explanation, BABs shall refer only to direct subsidy BABs. BABs is one tax advantage that is realized by the issuer of the bonds rather than the holder.

[3]The term "bank-qualified" is sometimes used to describe qualified tax-exempt obligations to reflect the fact that the ability of banks to avoid a significant portion of what would otherwise be disallowed as an interest expense deduction makes such bonds particularly attractive to banks and other financial institutions.

501(c)(3) bonds) not to be treated as an item of tax preference for bonds issued during those two years.[4]

As and when Congress changes the tax laws, including the ability to obtain a particular tax advantage and the detailed requirements for obtaining such tax advantage, it has sometimes, but not always, created transition (or "grandfather") rules for the refunding of bonds that themselves qualified for the particular tax advantage. These rules are often included in the Effective Date section of the legislation. The degree to which tax legislation creates such grandfather rules varies greatly, with the Tax Reform Act of 1986 being probably the most expansive in its use of transition rules.[5]

The tax advantages created under ARRA, including the ability to issue BABs and the increased dollar limit for qualified tax-exempt obligations, among others, are closer to the opposite end of the spectrum, where few, if any, rules were created to permit the refunding, post-ARRA, of ARRA-sanctioned bonds.[6]

Reason for Change

The variation from tax act to tax act in the inclusion of refunding transition rules creates a fair degree of uncertainty and, perhaps more importantly, an inherent unfairness in the application of new, presumably stricter, legislation to state or local bonds. While this proposal is not intended to be construed as supporting a "common law right to refund" a prior bond, the equities inherent in allowing an issuer to reduce its overall borrowing cost, or to restructure its debt for cash-flow purposes, so long as there is no increase in the outstanding amount of bonds and the average maturity of the refunding bond issue does not exceed 120% of the average reasonably expected economic life of the facilities being refinanced with the proceeds of such issue, seems fundamentally fair. Moreover, there should be little to no overall revenue loss to the federal government as a result of affording issuers this ability. In fact, since the contemplated transition rules would be limited to current refundings not exceeding the outstanding amount of the refunded bonds, and since many if not most refundings result in a reduction in the rate of interest paid by the issuer, such transition rules may actually result in revenue savings to the federal government.

While a broad statutory rule purporting to govern the ability to refund various types of bonds may be possible, often the ability to craft the appropriate rule may be dependent on the particular type of bonds at issue and the particular type of advantage sought to be preserved. To

[4]Section 57 of the Code, providing such AMT holiday, contains special rules for bonds issued to refund other bonds. Separately, section 56 of the Code provided a similar (though economically much smaller) holiday from the inclusion of the interest on governmental bonds and qualified 501(c)(3) bonds in corporate "adjusted current earnings."

[5]Section 1313 of the Tax Reform Act, for example, contains detailed rules for both current and advance refundings, allowing the preservation of certain more liberal pre-1986 Tax Reform Act "use of proceeds" rules.

[6]Although the AMT rules created by ARRA appear already to contain a refunding transition rule, it has been suggested that the likely intent of such rule was principally to prevent issuers from obtaining the AMT holiday with respect to certain refundings of pre-ARRA bonds (other than bonds issued between 2004 and 2008).

that end, one can make a strong argument that the Treasury is best equipped to create the appropriate refunding transition rule as part of its regulatory function.

Explanation of Provision

The proposed statutory language authorizes the Treasury to write appropriate refunding transition rules to preserve the tax advantage of particular types of bonds provided in the first instance that the refunding bond is a current refunding bond. This assures that there is at most 90 days' overlap in two tax-advantage bond issues being outstanding.[7] In addition, any such rule created by the Treasury pursuant to this authority would require that the average maturity of the refunding bond issue does not exceed 120% of the average reasonably expected economic life of the facilities being refinanced with the proceeds of such issue, and that the amount of the refunding bond issue does not exceed the outstanding amount of the bonds to be refunded by such issue.

[7] It is anticipated that this period will often be significantly shorter, particularly where the refunded bonds are variable rate bonds requiring relatively short advance notice for their redemption.

Draft Statutory Provision
Directing Treasury to
Provide Appropriate Refunding Transition Rules

SECTION ____. DIRECTION TO SECRETARY TO PRESCRIBE REGULATIONS TO PRESERVE TAX-EXEMPT STATUS OR OTHER FAVORABLE TREATMENT OF STATE OR LOCAL BONDS FOR CERTAIN CURRENT REFUNDINGS.

(_) IN GENERAL.—Section [150][1] is amended by adding at the end the following new subsection (f):

> (f) REFUNDING REGULATIONS. The Secretary shall prescribe such regulations as he/she may deem necessary in order that the tax-exempt status or other [tax-advantaged treatment][2] of a state or local bond (within the meaning of section 103(c)(1)) that is issued prior to the date after which such tax-exempt status or other [tax-advantaged treatment] would otherwise not be available will be made available to a bond issued after such date to refund (other than to advance refund) the prior bond (and to any bond that is part of a series of refundings of such prior bond) if:
>
> > (1) the average maturity of the issue of which the refunding bond is a part does not exceed 120% of the average reasonably expected economic life of the facilities being refinanced with the proceeds of such issue (determined under section 147(b)); and
> >
> > (2) the amount of the refunding bond does not exceed the outstanding amount of the prior bond.

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[1]This provision was initially drafted for its inclusion in Section 150 of the Code, which provides definitions and general rules generally applicable to Sections 103 and 141-149 of the Code. This section could alternatively be included in another section of the Code or in a non-codified section of the statute, with the objective of including within the benefits of this provision other sections that pertain to tax-exempt obligations, including Section 265(b)(3) of the Code, relating to the issuance of qualified tax-exempt obligations, and Sections 55-57 of the Code, relating to the alternative minimum tax.

[2]The term "tax-advantaged treatment" is intentionally left open for now, but could include build America bonds and qualified tax-exempt obligations.