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May 3, 2013

Internal Revenue Service
CC:PA:LPD:PR (Notice 2013-4)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Sent Via Email to Notice.Comments@irscounsel.treas.gov

Re: Comments in Response to Notice 2013-4 – Method of Determining Adjusted AFRs

On behalf of the National Association of Bond Lawyers (“NABL”), enclosed please find comments on the possible modifications to the method by which adjusted applicable Federal rates under section 1288(b) of the Internal Revenue Code of 1986, as amended (the “Code”), are determined. Please note that these comments are only applicable to the policies relating to tax-exempt bonds under section 1288(b) of the Code. Because NABL’s membership generally does not practice in the corporate tax realm, we are not commenting on the determination of the “adjusted federal long-term rate” for purposes of section 382(f)(2) of the Code.

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 Bill Daly in our Washington, D.C., office at (202) 503-3300.

Sincerely,

Scott R. Lilienthal

Enclosure

Comments in Response to Notice 2013-4 – Method of Determining Adjusted AFRs

Section 1274(d)(1) of the Internal Revenue Code of 1986, as amended,[1] provides that the applicable Federal rate ("AFR") equals: (i) in the case of a debt instrument with a term not over three years, the Federal short-term rate; (ii) in the case of a debt instrument with a term over three years but not over nine years, the Federal mid-term rate; and (iii) in the case of a debt instrument with a term over nine years, the Federal long-term rate. Section 1274(d)(1)(B) requires the Secretary of the Treasury to determine during each calendar month the rates that will apply during the following calendar month.

Section 1288(b) provides that, in applying section 483 or section 1274 to a tax-exempt obligation, appropriate adjustments shall be made to the applicable AFR to take into account the tax-exempt status of interest on the obligation (the adjusted rates established pursuant to section 1288(b), the "Adjusted AFRs"). The Internal Revenue Service publishes the Adjusted AFRs monthly in the Internal Revenue Bulletin.

Beginning with the publication of the Adjusted AFRs in November 1986, each Adjusted AFR has been determined monthly by multiplying the corresponding AFR by a fraction (the "Adjustment Factor"), the numerator of which is a composite yield of prime, general obligation tax-exempt bonds and the denominator of which is the composite yield of U.S. Treasury obligations with maturities similar to those of the selected tax-exempt bonds. When adopted in 1986, the intended result of the application of the Adjustment Factor was to reflect the difference between comparable tax-exempt and taxable obligations, without factoring in credit quality. As credit spreads between highly-rated tax-exempt obligations and U.S. Treasuries has widened, the application of the Adjustment Factor in determining Adjusted AFRs has led to unintended results. For example, in February 2013, the month in which Internal Revenue Service Notice 2013-4, 2013-9 I.R.B. 529 ("Notice 2013-4"), was published, the short-term, mid-term and long-term Adjusted AFRs all exceeded the corresponding AFRs, the effect of which is not only to ignore the tax exemption on tax-exempt bonds, but to ignore the actual experience of many issuers of tax-exempt bonds. Accordingly, NABL believes that the methodology for determining the Adjusted AFRs should be revisited and modified, as suggested in Notice 2013-4.

Although NABL sees merit in certain of the options presented in the Notice, NABL supports determining future Adjusted AFRs using a modified Adjustment Factor that is based on federal tax rates, i.e., option #2. NABL believes that, controlling for credit spreads, which is the most accurate way to reflect the benefit of federal tax exemption of interest on tax-exempt obligations, would require factoring in tax rates applicable to interest on federally-taxable municipal obligations. For purposes of establishing an "appropriate tax rate," NABL therefore suggests that the Service use the highest individual tax rate set forth in section 1, increased by the tax rate under section 1411 applicable to the investment income of individuals.[2] Such an approach would be simple to apply and consistent. NABL

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[2] Section 1411, which is effective for tax years beginning after December 31, 2012, and imposes a tax on certain individual taxpayers equal to 3.8% of the lesser of (1) net investment income, or (2) the excess, if any, of the modified adjustment gross income over the threshold amount, is the one tax we can think of currently that provides for an additional tax on fully taxable interest. We would expect that, if option #2 is the approach adopted by the Internal Revenue Service, other taxes on fully taxable interest enacted into future law that are in substitution of or in

recognizes that there is some rough justice in using the highest marginal income tax rate; however, there is much to be said for simplicity in administration.

NABL is of the view that the methodology outlined in option #1 of Notice 2013-4 suffers from the same flaw, albeit to a lesser extent, as the current methodology for determining the Adjustment Factor. While option #1 would prevent an Adjustment Factor of greater than 1, an Adjustment Factor of 1, absent extraordinary circumstances, would fail to properly reflect the tax exempt status of interest on tax-exempt obligations. For example, option #1 would not prevent a situation similar to that created under the current methodology for May of 2013, during which each of the short-term, mid-term and long-term AFRs and the corresponding Adjusted AFRs are the same.

While option #3 in Notice 2013-4 would, in most instances, account for the benefit of tax-exempt interest, we note that use of LIBOR or another variable taxable rate may result in wide variations from month-to-month and could result in situations where the Adjusted AFR is greater than the AFR.

NABL believes that option #4 in Notice 2013-4 is flawed in that it would ignore the most recent 6 years of Adjustment Factors in favor of averaging the Adjustment Factors for the prior 20 years of Adjustment Factors. While NABL understands that such an approach would serve to eliminate some of the odd results created by the current Adjustment Factor formula since the time of the financial crisis, option #4 is arbitrary and would seemingly require constant updating and decisions as to what years should be considered in determining the average percentage. Moreover, such a result would, by using an average over a period of time during which the benefit of tax-exempt interest varied (e.g., due to changes in income tax rates), fail to reflect the current benefit of tax-exempt interest for a particular month.

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addition to the tax under section 1411 would similarly be taken into account in determining adjusted applicable federal rates.