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December 16, 2013

VIA E-MAIL

Internal Revenue Service
CC:PA:LPD:PR (REG-148659-07)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
www.regulations.gov (IRS REG-148659-07)

Re: Proposed Arbitrage Regulations (REG-148659-07)

Ladies and Gentlemen:

The National Association of Bond Lawyers ("NABL") respectfully submits the enclosed comments relating to the proposed arbitrage regulations, REG-148659-07, which were published in the Federal Register on September 16, 2013 (the "Proposed Regulations"), except the proposed definition of "issue price." NABL is separately submitting comments on the definition of "issue price" in the Proposed Regulations. These comments were prepared by members of NABL's Tax Law Committee listed on Appendix I, and were approved by the NABL Board of Directors.

NABL appreciates the substantial efforts made by the Department of the Treasury and the Internal Revenue Service in the preparation of the Proposed Regulations and, as explained in the enclosed comments, believes that certain aspects of the Proposed Regulations should be finalized as soon as possible; however, as explained in our separate comments, NABL respectfully suggests that the proposed definition of "issue price" be withdrawn and that any other change in the issue price definition be re-proposed.

NABL requests an opportunity to speak at the public hearing to be held on February 5, 2014 at 10:00 AM. An outline of the topics to be discussed is attached as Appendix II.

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 you have any questions regarding the enclosed comments, please contact Bill Daly in our Washington, D.C., office at (202) 503-3300.

Sincerely,

Allen K. Robertson

Allen K. Robertson
President

COMMENTS OF THE NATIONAL ASSOCIATION OF BOND LAWYERS ON THE PROPOSED ARBITRAGE REGULATIONS PUBLISHED ON SEPTEMBER 16, 2013 EXCEPT THE DEFINTION OF "ISSUE PRICE"

INTRODUCTION

The National Association of Bond Lawyers ("NABL") respectfully submits the following comments on the proposed arbitrage regulations published on September 16, 2013[1] (the "Proposed Regulations"), except the definition " issue price." NABL is separately submitting comments on the definition of "issue price" in the Proposed Regulations.

NABL appreciates the substantial efforts made by the Department of the Treasury "Treasury") and the Internal Revenue Service ("IRS") in the preparation of the Proposed Regulations. The provisions in the Proposed Regulations relating to working capital, grants, qualified hedges and valuation provisions offer substantial improvements over the Existing Regulations and the technical comments and corrections we are making and suggesting below should be viewed in light of our overall appreciation of the approaches taken in these provisions.

As discussed below, NABL respectfully suggests that the proposed change in the anti-abuse rule be withdrawn. In our separate comments on the definition of "issue price" in the Proposed Regulations, we also respectfully suggest that the proposed definition of "issue price" be withdrawn. We recommend, however, that further work on these issues not delay finalizing the provisions in the Proposed Regulations relating to working capital, grants, qualified hedges and valuation provisions. We also recommend that the proposed regulations published on September 26, 2007 be finalized, subject to comments we have previously submitted, simultaneously with the provisions in the Proposed Regulations relating to qualified hedges.

COMMENTS

A. Working Capital and Grant Provisions

1. General Comments Regarding Working Capital

NABL commends Treasury and IRS for addressing and simplifying the regulations relating to working capital financing. The simplification of the working capital reserve calculation (*i.e.*, the deletion of the rule relating to directly or indirectly financing the reserve) is very helpful. Further, we appreciate that the Proposed Regulations retain the general

[1] Notice of Proposed Rulemaking and Notice of Public Hearing, 78 Fed. Reg. 56,842 (Sept. 16, 2013).

overburdening limitation in Reg. § 1.148-1(c)(4)(i)(A)[2] and add a reference to extraordinary working capital expenditures in Reg. § 1.148-10(a)(4).

NABL neither objects to nor endorses the proposed change to the final maturity safe harbor in Reg. § 1.148-1(c)(4)(i)(B)(1) from two years to the temporary period in Reg. § 1.148-2(e)(3). The change in the safe harbor from two years to (in most cases) 13 months is not particularly significant to most issuers. We do not, however, see any significant reason for the change.

2. Requests for Changes Regarding Working Capital

Clarification Regarding Restricted and *De Minimis* Working Capital Expenditures

The term "restricted working capital" is used to describe working capital expenditures that are subject to the "proceeds-spent-last" rule. Bonds issued to finance extraordinary working capital expenditures under Reg. § 1.148-6(d)(3)(ii)(B) and grants under Reg. § 1.148-6(d)(4) are not restricted working capital bonds. Accordingly, NABL recommends that Prop. Reg. § 1.148-1(c)(4)(i)(B)(1) be modified to include extraordinary working capital expenditures and grants. This could be accomplished by deleting the word "restricted" from Prop. Reg. § 1.148-1(c)(4)(i)(B)(1).

Further, some clarification would be useful regarding the treatment of *de minimis* working capital expenditures under Reg. § 1.148-6(d)(3)(ii)(A). We believe that the proposed working capital changes are not intended to change the treatment of *de minimis* working capital expenditures that are part of a related capital project. No changes are proposed to the definition of the term "capital project" in Reg. § 1.148-1(b) or to the safe harbor in Reg. § 1.148-1(c)(4)(i)(B)(2) that uses the term "capital projects" rather than "capital expenditure." Some confusion may arise, however, because the phrase "working capital expenditures" (as opposed to "restricted working capital") is used in Prop. Reg. § 1.148-1(c)(4)(i)(B)(4), and *de minimis* working capital expenditures are a type of working capital expenditures. It would be helpful if the final rules, or perhaps just the preamble for the final rules, make clear that the changes to Reg. § 1.148-1(c)(4)(ii) do not apply to *de minimis* working capital expenditures. While we think that extraordinary working capital expenditures and grants are intended to be covered, we also recommend that the preamble or final regulations clarify this point.

New Working Capital Financing Safe Harbor

We acknowledge that long-term working capital financings can present arbitrage compliance considerations. The structure of the existing rules in Reg. § 1.148-1(c)(4) focuses on the measurement and investment of "other replacement proceeds" to determine arbitrage

[2] On June 18, 1993, Treasury and IRS published comprehensive final regulations (T.D. 8476, 1993-2 C.B. 13) on the arbitrage investment restrictions and related provisions for tax-exempt bonds under sections 103, 148, 149 and 150 of the Internal Revenue Code of 1986, as amended (the "Code"). Since that time, those final regulations have been amended in certain limited respects. The regulations issued in 1993 and the amendments thereto are collectively referred to herein as the "Existing Regulations."

compliance in the context of potential overburdening. The explicit safe harbor for issuers to invest other replacement proceeds in non-AMT tax-exempt obligations as a means to avoid overburdening is a most welcome change. NABL proposes some changes, however, to the specific rule set forth in the Proposed Regulations.

First, it is logical for the amount of other replacement proceeds to be independently measured each year and for the related amount of required non-AMT tax-exempt investments to be independently measured each year. For example, $1 million of other replacement proceeds may exist in Year One, but no other replacement proceeds may exist in Year Two. The change in the Proposed Regulations could be interpreted to require that once non-AMT tax-exempt investments are acquired, the amount of such investments must be maintained for as long as the bonds are outstanding (subject to a universal cap-like rule), even if deficits exist in future years and there are no other replacement proceeds. This will prove difficult for issuers who need to utilize the funds otherwise invested in the non-AMT tax-exempt investments for operating purposes in later years. To remedy this problem, the aggregate amount of other replacement proceeds in any year should be based on the available amounts in existence that year. Such a determination should not be based on a cumulative calculation of all prior years.

Second, and consistent with the immediately preceding paragraph, the rule should provide that any non-AMT tax-exempt investments may be sold in order to allow the issuer to pay for working capital or capital expenses. It would be unduly burdensome to require an issuer to issue additional debt rather than to simply liquidate the non-AMT tax-exempt investments to cover capital or working capital expenditures that would otherwise create or contribute to a deficit.

Third, the proposed annual testing date for measuring whether other replacement proceeds exist may prove to be unworkable in many situations and should be more flexible. There are many potential approaches that add flexibility. The approach NABL advocates is to continue testing for other replacement proceeds on the first day of the fiscal year (or possibly a different date), but to alter the test so that it focuses on whether the issuer could otherwise issue short-term tax-exempt notes for restricted working capital purposes. If a dollar of tax-exempt notes could be issued for restricted working capital purposes, then the available amounts balance on the first day of the fiscal year is not too large. We acknowledge that this is an expectations test that focuses on the maximum anticipated cumulative cash flow deficit. If a short-term tax-exempt issue would be allowed, then there should be no other replacement proceeds. If not, then the amount of other replacement proceeds should be the lowest available amount projected during the annual testing period. If an expectations test is not acceptable by itself, this new test could be coupled with an actual facts requirement that would operate similarly to the determination of whether the rebate expenditure exception is satisfied for a short-term tax-exempt issue. If the actual maximum cash flow deficit does not result in there being no other replacement proceeds, then the issuer could be required to invest the actual other replacement proceeds amount in non-AMT tax-exempt investments until the next testing date.

Fourth, the regulations should make clear that the definition of “eligible tax-exempt bonds” includes investments in regulated investment companies meeting the 95% tax-exempt-interest requirement and in demand deposit SLGS, consistent with the definition of “tax-exempt bond" in Reg. § 1.150-1(b). Taking into account the existing definition, a statement in the preamble to the final regulations should suffice.

Fifth, while the new safe harbor could apply to bonds issued to finance extraordinary working capital expenditures and grants used for working capital expenditures, we suggest a rule be added that provides an additional safe harbor for extraordinary working capital expenditures and grants used for working capital, such as one tied to the useful life (to the issuer) of the applicable expenditures. See the discussion below regarding the useful life of grants.

Sixth, the proposed rules do not explicitly apply in the refunding context. It should be relatively easy to provide a basic "step in the shoes" approach providing that a refunding that occurs during the period prior to the end of the "first testing year" could be done without reference to future deficits at that time (picking up the same requirement to redeem bonds or invest in non-AMT tax-exempt investments after the originally determined first testing year). For a refunding that takes place after the first testing year, the issuer would have the option of either (a) downsizing the refunding by any available amounts at that time (a true "step in the shoes approach" with respect to the refunded obligations) and continuing to apply the same yearly test thereafter, or (b) starting a new analysis by treating the refunding as a new transaction under the rules (*i.e.* doing projections based upon a first testing year, and requiring that bonds be redeemed or monies be invested in non-AMT tax-exempt investments after the first testing year, *etc.*).

Seventh, the proposed rules allow purchases of an issuer's obligations with surplus amounts. This presumably includes any obligations of the issuer (not just the deficit financing issue). The rule, however, does not describe how these purchases are to be taken into account other than implying that such a purchase is an expenditure of the other replacement proceeds. It would be helpful to include a rule that treats purchases of an issuer's other debt as a reduction in the outstanding amount of the deficit financing issue under application of the universal cap rule. For example, if an issuer purchased $1 million of the issuer's capital project debt, the same amount of the deficit financing issue would deallocate for purposes of the other replacement proceeds testing rules, and any future required redemptions or non-AMT tax-exempt investments would be reduced accordingly.

<u>General Blending Approach for Other Replacement Proceeds Purposes</u>

The other replacement proceeds safe harbors should be clarified to expressly cover a single issue of bonds that finances capital and working capital expenditures. The working capital financing component should be treated as an asset with at least a zero useful life that is placed in service on the date the bonds are issued. If the weighted average maturity of the bond issue is not longer than 120% of the weighted average useful life of the financed assets (including the deemed working capital asset), then the issuer should be permitted to treat the bond issue as satisfying the other replacement proceeds safe harbor. As discussed above, this new rule would not apply to *de minimis* working capital expenditures.

<u>Financing a Working Capital Reserve</u>

As noted above in <u>Clarification Regarding Restricted and De Minimis Working Capital Expenditures</u>, the simplification of the working capital reserve calculation (*i.e.*, the deletion of the rule relating to directly or indirectly financing the reserve) is very helpful. Consistent with that simplifying change, it would be beneficial if the final regulations made clear that funding a working capital reserve with proceeds will be treated as an expenditure of those proceeds. Absent that clarification, an issuer would allocate all revenues received on and after the date the working capital bonds are issued to the funding of the working capital reserve, thereby allowing proceeds to be used for all expenditures until the reserve is fully funded. That accounting solution, however, is an unnecessary complication. An alternative solution would be to treat the funding of a working capital reserve similarly to the funding of a reasonably required reserve fund and add provisions comparable to Reg. §§ 1.148-2(f)(1), 1.148-2(f)(2)(i)-(iii), 1.148-7(c)(1)(ii) and 1.148-7(c)(3)(ii).

Treatment of Unspent Proceeds of Issue A as Unavailable for Purposes of Issue B

Although the proposed regulations do not propose changes to the definition of available amounts, there is one technical change that is warranted. The phrase "available amount excludes proceeds of the issue" in Reg. § 1.148-6(d)(3)(iii)(A) should be changed to "available amount excludes unspent proceeds of an issue." (Emphasis added.) This would allow an issuer to allocate the proceeds of a tax-exempt working capital issue to expenditures even if proceeds of another (taxable or tax-exempt) working capital issue were not spent. See the analysis in Private Letter Ruling 200446006.[3]

The importance of this change is best shown by example. For simplicity, we ignore the working capital reserve. City expects a deficit of $100 to occur in December but is not certain. In the previous July, to be careful, City issued only $70. A couple months later it is clear that the $100 deficit will occur, and City issues another $30. At the time of the second issue, $40 of the proceeds of the first issue are not yet spent. If the unspent proceeds of the first issue are available for purposes of spending the proceeds of the second, and the unspent proceeds of the second issue are available for purposes of spending the proceeds of the first, then none of the proceeds of either issue can be treated as spent.

3. General Comments Regarding Grants

NABL wishes to commend Treasury and IRS for addressing and clarifying the treatment of grants. We endorse the general "look-through" approach set forth the in the Proposed Regulations, subject to the comments set forth below.

4. Requests for Changes Regarding Grants

Issues Relating to Grants for Working Capital

Useful Life of Grants: While the general look-through approach for grants is a useful clarification, NABL proposes some changes relating to the interaction between the look-through approach and the overburdening and other replacement proceeds concepts. Consider a grant made to a business to induce the business to relocate into a downtown business district for urban renewal purposes. A common structure is that the grant would be used to cover operating costs

[3] IRS Letter Ruling 200446006 (Jul. 15, 2004).

of the business, and the business would commit to maintaining its presence in the downtown business district for five years. Strictly applying the look through approach, the grant is for working capital expenses incurred by the business. Viewing the grant from the issuer's perspective, however, the grant has essentially acquired an intangible asset (the relocation of the business) with a five-year life.

It would be very helpful if a rule and some examples are added that allow issuers to establish a "useful life" for grants by reference to the time period the issuer is reasonably expected to benefit from the grant. In simple cases, like the example above, a contractual compliance period embedded in the grant could be used. But, not all working capital grants have a formal contractual compliance period. If the amount and purpose of a grant was, for example, to fund three years of operating deficits for a start up enterprise, the expected life of the grant to the issuer should be three years even if there is not a strict three-year compliance period included in the contractual terms of the grant.

As noted above, any such rule added for grants should also apply to extraordinary working capital expenditures.

General Blending Approach: If the general blending approach for other replacement proceeds (described above) is not adopted for all working capital financing purposes, it should at least be adopted for issues that finance both capital projects (funded through grants or otherwise) and working capital grants. We can think of no reason why such a blending approach is inappropriate.

Grantee Reimbursement: The final regulations should confirm that the look through approach does not require the grantee to satisfy any sort of official intent requirement to the extent a grant is made on a reimbursement basis. It is most common for issuers administering grant programs to transfer funds to grantees only after the grantee has provided documentation showing that the grantee has spent its own funds for the purposes of the grant. If an official intent requirement applied and was not satisfied in this "reimbursement" context, then a traditional grant for a capital project would transform into a working capital grant.

Refunding Analysis: The final regulations should confirm that the look through approach does not cause bonds issued to finance grants to be refunding bonds if the grantee uses the grant to pay debt service on the grantee's obligations. This non-refunding conclusion is consistent with the refunding definition in Reg. § 1.150-1(d)(2)(ii), because the grantor will not be a related party to the grantee. Thus, the obligors on the two issues of obligations will not be related. This clarification is important because grantees frequently incur debt to finance project costs and use the grant funds to pay off that debt.

B. *Qualified Hedge Provisions*

1. Changes in accounting for qualified hedges in connection with deemed terminations (Prop. Reg. § 1.148-4(h)(3)(iv)(C) and (D))

By way of background, in April 2007, NABL submitted a letter to Treasury requesting guidance on the deemed termination of a qualified hedge in connection with the acquisition of an offsetting hedge. In the proposed regulations published on September 26, 2007 (the "2007 Proposed Regulations"),[4] Treasury and IRS requested specific comments on this topic. NABL's comments in December 2007 specifically requested changes to the qualified hedge rules to avoid the consequences of a deemed termination of a qualified hedge in connection with the modification of a hedge or refunding of the hedged bonds (including a deemed reissuance). The Proposed Regulations broadly respond to that request. NABL thanks Treasury and IRS.

Prop. Reg. § 1.148-4(h)(3)(iv)(C) provides that the modification of a qualified hedge that otherwise would result in a deemed termination will not be treated as a termination if the modified hedge meets the requirements for a qualified hedge, determined as of the date of the modification. Prop. Reg. § 1.148-4(h)(3)(iv)(D) provides that what otherwise would be a deemed termination of a qualified hedge as a result of redemption of the hedged bonds will not be treated as a termination, and the hedge will be treated as a qualified hedge of the refunding bonds, if it meets the requirements for a qualified hedge as of the issue date of the refunding bonds. In both cases, the fact that the existing hedge is off-market as of the date of the modification or refunding, as the case may be, is disregarded. In addition, the new certification requirement is waived, and the period in which the hedge must be identified is measured as of the new testing date.

These proposed changes are very helpful for the reasons stated in our December 2007 comment letter. When read in conjunction with other aspects of the 2007 Proposed Regulations, however, they are incomplete. The 2007 Proposed Regulations would amend the qualified hedge rules by modifying the interest based contract rule to require, in the case of an interest rate swap based on a taxable interest rate, that the difference between the rate on the swap and the rate on the hedged bonds cannot exceed 25 basis points both at the time the issuer enters into the hedge and for a three-year period prior thereto (the "interest rate correlation test").

While not entirely clear, we are concerned that the new proposed rule on potential deemed terminations could be read to require testing for compliance with the interest rate correlation test at the time of the modification or refunding to determine if the modified or existing hedge is a qualified hedge.[5] That would greatly limit the utility of the new rules.

In our December 2007 comments we suggested that the interest rate correlation test was unnecessary in light of other rules. But we also suggested that, if some form of interest rate

[4] Notice of Proposed Rulemaking and Notice of Public Hearing Arbitrage Guidance for Tax-Exempt Bonds, 72 Fed. Reg. 54,606 (Sept. 26, 2007).

[5] Disregarding any off-market aspect of the modified or existing hedge might be interpreted to include any noncompliance with the interest rate correlation test, but that seems an unlikely inference.

correlation is required, it be limited to a form of three-year historical correlation. Assuming that is what is finally adopted, we urge Treasury and IRS not to require its application in connection with potential deemed terminations as a result of a modification or refunding. One of the great benefits of the new proposed rules is that an issuer will not have to negotiate with an existing hedge provider to maintain the qualified status of its hedge when a potential deemed termination occurs. This is most commonly the case in connection with refundings of hedged bonds (including deemed reissuances), but it can also occur in connection with deemed modifications as a result of new interest rate positions entered into with a counterparty different from the original hedge provider. If the interest rate correlation test must be satisfied as of the date of modification or refunding, the issuer will almost certainly have to deal with the original hedge provider to ensure compliance.

Interest rate correlation in these circumstances should be unnecessary, because a single rate correlation test can always be satisfied with a meaningless adjustment to the rate formula. For example, assume an issuer's three-year historical interest rate for a particular rate period has averaged 2%, and the issuer has an existing interest rate swap where the issuer pays 4% fixed and receives 67% of LIBOR (which satisfied the interest rate correlation test at the time it was entered into). If LIBOR for the three-year test period prior to a refunding has averaged 2.46%, 67% of LIBOR for that period would have averaged 1.60%--more than 25 basis points different from 2%. That difference can be eliminated by changing the interest rate formula on the swap by adding 40 basis points to each side of the equation, to make the fixed rate 4.40% and the variable rate 67% of LIBOR plus 40 basis points. Simple algebra will prove that those two rate formulas will always produce the same net number, and the same will be true for virtually any other set of rate formulas. That is easy enough to do when the swap is being entered into, when both parties to the contract are at the table.[6] It would entail needless expense in time and money, however, when the contract is not otherwise being altered.

As an alternative to abandoning the interest rate correlation test altogether, we suggest the issuer be permitted to satisfy that test by maintaining documentary evidence that the test could have been satisfied with an adjustment to the interest rate provisions in the swap that would have produced no net change in payments under any set of interest rate assumptions.

We also assume that these rules, if finally adopted, will supersede Section 5.1 of Notice 2008-41[7], dealing with modifications of qualified hedges.

2. Definitions of modification, termination for qualified hedges (Prop. Reg. § 1.148-4(h)(3)(iv)(A) and (B))

We have no specific comments to these provisions, but we do have the following observations.

The removal of the phrase "acquisition by the issuer of an offsetting hedge" from the definition of a termination is an improvement to the rules.

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[6] But that is also one of the reasons we suggested before that an interest rate correlation test is unnecessary.

[7] I.R.B. 2008-15, 742.

The assignment of a hedge provider's remaining rights and obligations under the hedge to a third party is treated as a modification under Prop. Reg. § 1.148-4(h)(3)(iv)(A) but is treated as a termination under Prop. Reg. § 1.148-4(h)(3)(iv)(B) only if that causes a realization event to the issuer under section 1001. Presumably that covers an assignment that is not treated as an exchange under Reg. § 1.1001-4. If the assignment rule is intended to have some other application, please clarify.

We read the Proposed Regulations as providing that a partial redemption of hedged bonds results in a partial deemed termination of a qualified hedge.

We also read the Proposed Regulations as allowing an issuer to modify a qualified hedge by executing a second hedge and integrating the two hedges with the bonds without the need for a hedge provider's certificate (assuming the other integration requirements are met).

3. Fair market value standard for termination of qualified hedge (Prop. Reg. § 1.148-4(h)(3)(iv)(E))

The 2007 Proposed Regulations would modify the existing regulations to provide that the amount of any termination payment or deemed termination payment taken into account for arbitrage yield calculations is equal to the fair market value of the hedge on the termination date. In our December 2007 comments, we asked that the proposed rule be changed to make it clear that the actual amount paid or received by the issuer be treated as the fair market termination value and that deemed termination value be based on actual market quotations. The Proposed Regulations leave the fair market value standard for deemed terminations unchanged from the 2007 Proposed Regulations and add a rule that, in the case of an actual termination, the amount taken into account cannot be more than fair market value if the termination payment is paid by the issuer and cannot be less than fair market value if the termination payment is paid by the provider. Although the Preamble states that these changes were made in response to comments, there is no further gloss on what the new proposal is intended to address.

In our December 2007 comments, we explained that in most cases hedge termination payments are determined initially by the provider based on its pricing models and typically reflect the "bid side" of the hedge provider's quotation system. Standard swap documentation usually provides for a market quotation procedure if the issuer disagrees with the providers' termination amount, which will again be based on the "bid side." This is the same system used for interest rate swaps for non-municipal counterparties, and we are unaware of any suggestion that it produces off-market results. Especially in the case of an actual termination payment, the termination amount is a real number to the issuer, either a real cost or a real revenue; a bond yield adjustment will at best only partially compensate an issuer for an off-market termination amount.

In view of standard practice throughout the market and the administrative development of this new proposed rule, what is the implication of the Proposed Regulations' treatment of termination amount values? If the concern is that costs unrelated to the hedging transaction are embedded in a swap termination value, we submit that, under the existing final regulations, this would be a proper subject of an audit challenge. If Treasury and IRS have additional concerns, we request that the preamble for final regulations provide some explanation.

Moreover, the landscape for derivatives has changed tremendously since 2007, most notably by enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act.[8] Under the price transparency rules for interest rate swaps contained in Dodd-Frank, municipal issuers and their advisors (and all municipal issuers are required under Dodd-Frank to have swap advisors) have real-time pricing information to help them determine the true value of their swaps.

We urge Treasury and IRS to revert to the 2007 Proposed Regulations statement of fair market value rule, with the changes suggested in our December 2007 comments:

> (i) in the case of an actual termination of a qualified hedge, the termination amount is the amount paid by or to the issuer in respect of such termination, and
>
> (ii) in the case of a deemed termination of a qualified hedge, the termination amount is the fair market value determined by the issuer (taking into account any quotation of such value obtained from the provider and any quotation obtained from a reasonably comparable provider).

In all events, Treasury and IRS should recognize that real world termination values reflect the "bid side" of the market.

Finally, it is unlikely that there will be a single universally agreed upon fair market value for a hedge (different buyers will be willing to pay different prices for the same product). In other contexts (*e.g.*, fair market value for issue price), industry practice has developed to permit parties to certify that a price represents "a fair market value." The final regulation should use the words "a fair market value" or simply "fair market value" in place of "the fair market value."

4. Requires specific hedge provider certifications for qualified hedge treatment (Prop. Reg. § 1.148-4(h)(2)(viii)(A) and (B))

The Proposed Regulations would impose a hedge provider's certification requirement for qualified hedges. This requirement seems unnecessary for several reasons. First, it would impose a requirement on qualified hedges that is not present as a matter of law for other financial contracts that are includable in yield. For example, there is no similar requirement for bond insurance or letters of credit, although we acknowledge similar provisions relating to the investment of bond proceeds in guaranteed investment contracts. Issuers have strong legal, market and economic incentives to seek the most competitive swap counterparties.

Second, interest rate swaps and other hedges function as a form of interest rate protection, similar to the credit risk protection provided by a guarantee. Under existing final regulations, if an issuer acquires a qualified guarantee, the fees includible in bond yield cannot exceed a reasonable arm's-length charge for the transfer of credit risk.[9] Importantly, in complying with

[8] Pub. L. No.111–203, 124 Stat. 1376.

[9] *See* Reg. § 1.148-4(f)(4)(i).

this requirement, the issuer may not rely on the representation of the guarantor. It would be inconsistent for the qualified hedge regulations to have disparate treatment between qualified hedges and qualified guarantees.

Third, hedge integration is not unique to the tax-exempt bond area, and the Proposed Regulations requirement for a hedge provider's certificate is unprecedented. More specifically, none of the hedge integration regulations set forth under sections 446, 988, 1221 and 1275 contains a requirement of a hedge provider's certificate. Of course, issuers have been integrating hedges with tax exempt bonds for over 20 years. There should be strong reasons for imposing a different requirement in the tax-exempt bond law than the tax law generally.

If Treasury and IRS seek to set forth an explicit "fair market price" concept to qualified hedges, final regulations should provide for alternative methods of establishing fair pricing, which could include a hedge provider's certificate, internal analysis, or a report of a qualified independent representative meeting the standards of the Commodity Futures Trading Commission. Some interest rate swaps are bid, with the issuer specifying the variable rate leg and the swap being awarded to the lowest fixed rate bidder, which also should be enough to conclusively establish fair pricing.

We recognize, of course, that many issuers (at the instigation of bond counsel) already require some form of hedge provider certifications, and it is unlikely to be coincidence that the content of the provider certificate in the Proposed Regulations reflects to some degree a standard form of such certification. Nonetheless, we strongly believe the final regulations should set forth the substantive requirements for qualified hedge treatment and let the market develop appropriate diligence standards for implementing those requirements.

If Treasury and IRS decide to retain the certification requirement, the four representations should be clarified. As a general matter, we believe that the form of the certificate and the precise phraseology should not dictate the tax result. The issuer should be required to demonstrate that it used its best efforts to establish that (1) the rate payable by the issuer does not include compensation for underwriting or other services, and (2) the rate was comparable to the rate that the hedge provider would charge for a similar hedge with a counterparty similar to the issuer (if one exists). The lack of a comparable hedge or comparable hedge counterparty should not preclude hedge integration.

Specifically, we see little value in the representation that the terms of the hedge were agreed to between a willing buyer and willing seller in a *bona fide*, arm's length transaction. Hedges are typically (though not always) negotiated transactions, and issuers frequently use swap advisors (or internal expertise) to evaluate transactions. As drafted, the representation is a legal conclusion that appears to create a "foot fault" to reverse integration.

The rate comparability representation in Prop. Reg. § 1.148-4(h)(2)(viii)(B)(2) is generally fine but the reference to "debt obligations other than tax-exempt bonds" should be deleted. Many tax exempt bond issuers do not issue taxable bonds. The legal, credit and other market factors present in hedges with tax exempt issuers are materially different from the same factors with taxable entities as a counterparty. Accordingly, the party executing the certificate often is not able to make a comparison to “debt obligations other than tax-exempt bonds” with a similar counterparty.

We have one minor comment to the disclosure of third-party fees as required by Prop. Reg. § 1.148-4(h)(2)(viii)(B)(3). This subparagraph should make clear that only third-party fees paid at the request (or for the benefit) of the issuer must be disclosed in the certificate. Third-party fees, such as legal and accounting fees, paid by the hedge provider for the benefit of the hedge provider should not be required to be disclosed. This clarification would be consistent with current market practice.

Prop. Reg. § 1.148-4(h)(2)(viii)(B)(4) is unclear. From the hedge provider’s perspective, it is offering to enter into a bilateral contract with the issuer. It is inappropriate for the hedge provider to address whether the hedge modifies the issuer’s risk of interest rate changes. Similarly, it is inappropriate for the hedge provider to represent that the payments are reasonably allocated to the hedge provider’s overhead. We assume that Treasury was concerned about hedge providers embedding fees for other services within a hedge. Market practice has addressed this issue effectively. In general, bond counsel have asked hedge providers whether amounts payable by the issuer pursuant to a qualified hedge include payments for underwriting or other services provided by the hedge provider. If the hedge provider makes payments on behalf of the issuer (*e.g.*, to a financial advisor or swap advisor to the issuer), those services are typically disclosed. As drafted, the Proposed Regulations would not allow an issuer to integrate a hedge with a separately stated investment element or fee even if fully disclosed and properly quantified. If Treasury and IRS retain the hedge provider’s certificate requirement, we recommend that Prop. Reg. § 1.148-4(h)(2)(viii)(B)(4) be replaced with a requirement that the hedge provider certify either (1) that there are no underwriting or other services unrelated to the hedge provider’s obligations under the hedge, or (2) the nature of the services and the rate that the hedge provider would have quoted to the issuer to enter into the hedge absent such services.

5. Identification (Prop. Reg. § 1.148-4(h)(2)(viii))

Most of the requirements for qualified hedge treatment apply to the “issuer,” which in the case of a conduit financing means either the actual issuer or the conduit borrower, depending on the context.[10] In Reg. § 1.148-4(h)(2)(viii), however, the identification of a hedge must be made by the actual issuer. Especially in the case of anticipatory hedges, a conduit borrower may not know for sure which entity will be the actual issuer of the bonds. In conduit financings, the final regulations should permit the identification to be made on the books and records of the conduit borrower. The actual issuer would still be required to identify the existence of the hedge on the information return filed with respect to the issue. Moreover, listing the hedge on the information return should be treated as inclusion in the issuer’s books and records and address any concerns that IRS may have regarding the issuer being familiar with the hedge.

[10] Reg. § 1.148-1(b).

6. Prop. Reg. § 1.148-4(h)(4)(iv) Applies Reg. § 1.148-4-4(h)(4)(iii) to Reg. § 1.148-4-4(h)(3)(iv)(C)

The Proposed Regulations would add a new paragraph 1.148-4(h)(4)(iv) as follows—

> <u>Consequences of certain modifications</u>. The special rules under paragraph (h)(4)(iii) of this section regarding the effects of terminations of qualified hedges of fixed yield hedged bonds also applies in the same manner to modifications of a qualified hedge under paragraph (h)(3)(iv)(C) of this section. Thus, for example, a modification may result in a prospective change in the yield on the hedged bonds for arbitrage rebate purposes under Reg. § 1.148-3.

This would be added to the so-called super-integration rules. In general, the rules under Reg. § 1.148-4(h)(4)(iii) provide, in connection with termination of a super-integrated hedge, that (A) the hedged bonds are treated as reissued on the termination date in determining yield for purposes of Reg. § 1.148-3 (dealing with rebate), (B) if the termination occurs within five years of the issue date of the hedged bonds, the bonds are treated as variable yield bonds from their issue date for purposes of Reg. § 1.148-3, and (C) the termination rule does not apply to a termination if, based on the facts and circumstances (*e.g.*, taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in yield.

We understand that the purpose of this proposed rule is to ensure that a qualified hedge that is super-integrated under Reg. § 1.148-4(h)(4)(i) is retested for super-integration after a modification that would not be treated as a termination under the Prop. Reg. § 1.148-4(h)(3)(iv)(C) rule (modification does not result in a deemed termination if the fact of its being off-market is disregarded). If that understanding is correct, we suggest the rule could be clarified if the first sentence were rewritten as follows—

> Notwithstanding the rule on modification of a qualified hedge under paragraph (h)(3)(iv)(C) of this section, modification of a qualified hedge that would result in a termination in the absence of the rule in paragraph (h)(3)(iv)(C) will not be treated as a termination for purposes of this paragraph (h)(4)(iii) if the rule in subparagraph (h)(4)(iii)(C) applies.

C. *Valuation of Investments*

We commend Treasury and IRS for proposing changes to the valuation rules set forth in the arbitrage regulations. We believe that, with appropriate revisions prior to finalization, the changes will be helpful to issuers of tax-exempt bonds and will further the general policies behind the arbitrage rules set forth in section 148, as more specifically described in Reg. § 1.148-0: to minimize arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove arbitrage incentives to issue more bonds, to issue bonds earlier, and to leave bonds outstanding longer than is otherwise reasonably necessary.

1. Background

The Existing Regulations generally require that investments allocated to or from an issue of tax-exempt bonds in a deemed acquisition or deemed disposition must be valued at fair market value as of the date of the deemed acquisition or disposition, with exceptions for investments allocated from one issue of tax-exempt bonds to another issue of tax-exempt bonds as a result of the transferred proceeds allocation rule or the universal cap rule. As noted in the preamble to the Proposed Regulations, these valuation rules have the effect of preventing issuers from retiring outstanding tax-exempt bonds prior to their stated maturity date in cases where yield restricted investments allocable to the issue have appreciated in value to such an extent that fair market valuation at the time of deemed disposition will result in violation of applicable yield restriction limitations under section 148. This disincentive to retiring tax-exempt bonds prior to maturity is contrary to the underlying principle of the arbitrage rules because it results in tax-exempt bonds staying outstanding longer than is otherwise necessary.

One of the more common scenarios illustrating this effect involves an issuer's taking of "remedial action" pursuant to Reg. § 1.141-12(d), in which investments allocated to the bond issue with respect to which remedial action is taken are still in place and, hence, need to be valued. In that scenario, an issuer that does not have on hand sufficient funds to effectuate the redemption or defeasance required under Reg. § 1.141-12(d) will be forced to borrow on taxable basis to provide the funds necessary to redeem or defease bond issue in question.

A second scenario, of which IRS is aware, involves the many tax-exempt bond issues that have been defeased past their first optional call date, where call rights have been retained by the bond issuer. There are numerous permutations of situations in which it may be necessary or desirable for a bond obligor to retire such bonds ahead of the date to which they have been defeased. Examples illustrating the above two scenarios are as follows:

Example 1. In June 2005, City X issues long-term fixed-rate tax-exempt bonds to finance the construction of a new 10-story office building in which the City intends to house some of its employees. The 2005 bonds are first callable at the option of City X on November 1, 2015 at par. Construction of the building is completed in June 2007. In August 2007, City X issues variable rate demand bonds, at par (and concurrently enters into a variable-to-fixed interest rate swap), to advance refund the 2005 bonds to their first optional call date, November 1, 2015. City X integrates the interest rate swap with the 2007 bonds pursuant to the rules in Reg. § 1.148-4(h). The integrated yield on the 2007 bonds, using the fixed rate on the swap, is 5.00%, and the yield on the escrow securities used to defease the 2005 bonds is 4.95%. On September 30, 2013, City X leases for fair rental value 5 of the 10 floors in the building to Company Y. City X intends to redeem 50% of the outstanding amount of the 2007 bonds within 90 days of September 30, 2013, in accordance with Reg. § 1.141-12(d)(1), and issues taxable bonds in an amount sufficient (after issuance costs) to redeem 50% of the 2007 bonds within such period. At the time of issuance of the 2013 taxable bonds, the escrow securities have a fair market value that, if sold, would cause the yield on the escrow securities to exceed the integrated yield on the 2007 bonds. Under Reg. § 1.148-9(b)(1), 50% of the investments held in the escrow established with the 2007 bonds to defease the 2005 bonds will be deallocated from the 2007 issue and become "transferred proceeds" of the 2013 taxable bonds.

Example 2.[11] In 2002, City X issues tax-exempt bonds to finance eligible costs. In 2006, City X used non-borrowed funds (*i.e.*, equity) to purchase escrow securities and create an escrow restricted to the yield on the tax-exempt bonds and defease the tax-exempt bonds to maturity. The yield on the tax-exempt bonds is 5.00% and the yield on the escrow securities is 4.95%. The early call option(s) on the tax-exempt bonds are retained by City X. In 2013, City X issues taxable bonds and uses a portion of the proceeds to redeem the tax-exempt bonds on the same date. The amount of taxable bonds that may be issued and supported by cash flows from the escrow securities exceeds the amount required to redeem the tax-exempt bonds and the excess proceeds derived from the taxable bonds are used by City X for lawful governmental purposes. At the time of issuance of the 2013 taxable bonds, the escrow securities have a fair market value that, if sold, would cause the yield on the escrow securities to exceed the yield on the 2002 tax-exempt bonds. Applying universal cap principles, at the time the 2002 tax-exempt bonds are redeemed, the escrow securities cease to be allocated as replacement proceeds of the tax-exempt bonds and, because they are used thereafter to secure the repayment of the taxable bonds, they become replacement proceeds of the taxable bonds.

In both of the above examples, an arbitrage violation would occur if the escrow securities are required to be valued at fair market value at the point at which they cease to be allocated to the tax-exempt bond issue. An arbitrage violation would not occur if the escrow securities are valued at present value at such time. Pursuant to current Reg. § 1.148-5(d)(3)(ii), however, the escrow securities arguably are required to be valued at fair market value unless, as a result of a transferred proceeds allocation under Reg. § 1.148-9(b) or the universal cap rule under Reg. § 1.148-6(b)(2) the escrow securities both (1) cease to be allocated to one issue of tax-exempt bonds, and (2) at the same time are allocated to a different issue of tax-exempt bonds. Under this reading of the current valuation regulations, the issuer in Example 1, who has no choice but to issue taxable indebtedness to defease the currently outstanding debt in order to effect remedial action, is unable to do so. Likewise, the Existing Regulations impede the taxable refunding described in Example 2.

The preamble to the Proposed Regulations notes the disincentives to the early retirement of tax-exempt bonds created by the current rules and acknowledges that such disincentives are inconsistent with general arbitrage policies. The preamble specifically states that the current regime "creates disincentives against retiring tax-exempt bonds . . . when the fair market value of the investment would cause investment yield to exceed the tax-exempt bond yield. Such disincentive is inconsistent with the general policies behind the arbitrage rules stated in Section 1.148-0."

We applaud the approach reflected in the Proposed Regulations, but we believe the policy of removing disincentives to early retirement of tax-exempt bonds can best be achieved with certain clarifications and supplements. Additionally, given the age of the current valuation rules, and 20-plus years of experience with the current regime, we recommend a reordering and simplification of the valuation rules and certain specific changes.

[11] We understand that numerous issuers have approached IRS in connection with potential private letter ruling requests and closing agreements in connection with seeking relief in circumstances similar to this Example 2. Presumably, the proposed changes in the valuation provisions in the Proposed Regulation are in response to issuers raising such circumstances with IRS.

2. Clarifications

We request that, when the Proposed Regulations are finalized, the regulations be clarified in the following manner.

Effective Date

As written, the Proposed Regulations can be applied only with respect to *bonds sold* on or after September 16, 2013. In the context of a taxable refunding, a valuation at fair market value adversely impacts the yield restriction and rebate position of the refunded bonds and not the refunding bonds, which are taxable in any event. It is unclear whether the phrase “bonds sold” in the effective date provision is referencing the refunded tax-exempt bonds or the refunding taxable bonds. If it is referencing the date of sale of the refunded tax-exempt bonds, it will be many years before the change in the regulations has any significant utility since in the most common fact pattern to which this rule will apply, first, tax-exempt bonds must be issued after September 16, 2013; second, after a period of time, the bonds must be refunded with tax-exempt refunding bonds; and finally, the taxable bonds would need to be issued to refund the tax-exempt refunding bonds.

As noted above, the preamble to the Proposed Regulations acknowledges that the fair market valuation rule in the Existing Regulations creates a disincentive to the issuance of taxable refunding bonds, which is inconsistent with the policies behind the arbitrage rules. The Proposed Regulations attempt to remedy this disincentive. In order to do so effectively, it should be clarified that the effective date is based on the date on which the refunding taxable bonds are sold. Alternatively, particularly if our suggestion in Section 3 (Extend Valuation Rule to Apply to Redemption with Equity Funds) is adopted, the new provision should be applicable with respect to deallocations under the transferred proceeds, universal cap or replacement proceeds rules occurring on or after September 16, 2013.

Application of Universal Cap Rule in the Context of Equity-Funded Escrows

As illustrated in Example 2 above, the policy of encouraging the early retirement of tax-exempt bonds would be best served if the escrow securities are permitted to be valued at present value when they cease to be allocated to tax-exempt bonds and are reallocated to taxable refunding bonds. Under the Proposed Regulations, such a result occurs if the transfer of the escrow securities from the tax-exempt bonds to the taxable bonds occurs as a result of either the transferred proceeds allocation rule under Reg. § 1.148-9(b)[12] or the universal cap rule under Reg. § 1.148-6(b)(2). The escrow securities do in fact cease to be proceeds of the tax-exempt bonds as a result of the universal cap rule. While this deallocation enables the escrow securities to become proceeds of the taxable bonds, it does not cause such a reallocation to occur. The universal cap rule generally does not cause amounts to be proceeds of an issue because it is a rule that operates to limit the amount of proceeds that can be allocated to an issue. The Proposed Regulations simply require that the allocation from the tax-exempt issue to the taxable issue

[12] In Example 2, the transfer does not occur as a result of the transferred proceeds allocation rule under Reg. § 1.148-9(b). This rule applies only to sale proceeds and investment proceeds of a bond issue. The escrow securities are neither sale proceeds nor investment proceeds of the tax-exempt bonds, but are instead replacement proceeds.

occur "as a result" of the universal cap rule. In our Example 2, the universal cap rule is one of the factors that enables the investments to become replacement proceeds of the taxable bonds. Moreover, permitting valuation of the investments at present value in this context is consistent with the tax policy goal of removing disincentives to the retirement of tax-exempt bonds prior to their stated maturity date.[13] Accordingly, we propose that the following example be added to the revamped valuation regulations:

> *In 2002, City X issues tax-exempt bonds to finance eligible costs. In 2006, City X used non-borrowed funds (*i.e.*, equity) to purchase escrow securities and create an escrow restricted to the yield on the tax-exempt bonds and defease the tax-exempt bonds to maturity. The yield on the tax-exempt bonds is 5.00% and the yield on the escrow securities is 4.95%. The early call option(s) on the tax-exempt bonds are retained by City X. In 2013, City X issues taxable bonds with a comparable maturity structure to the outstanding 2002 tax-exempt bonds and uses a portion of the proceeds to redeem the tax-exempt bonds on the same date. Only $100 of taxable bonds is needed to retire the tax-exempt bonds, but the escrow securities would provide sufficient cash flow to support $115 of taxable bonds. City X issues $115 of taxable bonds, and $100 of the proceeds are used to retire the tax-exempt bonds and $15 of the proceeds are used for any lawful purpose of City X.[14] At the time of issuance of the 2013 taxable bonds, the escrow securities have a fair market value that, if sold, would cause the yield on the escrow securities to exceed the yield on the 2002 tax-exempt bonds. Applying universal cap principles, at the time the 2002 tax exempt bonds are redeemed, the escrow securities cease to be allocated as replacement proceeds of the tax-exempt bonds and, because they are used thereafter to secure the repayment of the taxable bonds, they become replacement proceeds of the taxable bonds. At the time the escrow securities cease to be allocated to the tax-exempt bonds, the escrow securities are valued at present value.*

<u>Clarify Valuation Treatment of Purpose Investments</u>

While the Existing Regulations are not clearly written on this point, we understand that the intended result of the Existing Regulations is that purpose investments[15] are to be valued at

[13] We acknowledge that this tax policy goal must be balanced against other potential consequences of this proposed change, such as possibly creating an incentive to defease callable bonds to maturity rather than currently redeem them. If IRS is concerned about creating an incentive, in the form of an updated valuation rule, for issuers to apply available funds to defease tax-exempt bonds to maturity while retaining their optional call right, IRS could create a rule (or even a safe harbor) within Reg. § 1.148-10 that provides that an issuer that sets aside its own funds for the retirement of tax-exempt bonds will not be treated as keeping bonds outstanding longer than necessary if the term of the escrow created with respect to such debt was necessary (i) to avoid a redemption premium with respect to the defeased bonds, or (ii) to avoid the investment of the escrow securities at a yield more than a basis point below the yield on the defeased bonds.

[14] The economics of this transaction are similar to the economics of a sale of the escrow securities.

[15] This result is sensible because purpose investments generally are not negotiable instruments for which there is a readily ascertainable market or value and should never be subject to a market-to-market requirement, even when transferring between taxable and tax-exempt bond issues. Additionally, purpose investments will regularly

present value at all times (the language of existing Reg. § 1.148-5(d)(2) describes a purpose investment as an example of an investment that is subject to mandatory valuation at present value). While we believe this approach is intended to be continued under the Proposed Regulations, the preamble and language of the Proposed Regulations could be interpreted as creating uncertainty (the preamble states "the fair market value method of valuation is generally required for *any* investment and the purpose investment example is removed from the language of Reg. § 1.148-5(d)(2)).[16] This uncertainty can be avoided by specifically stating in Reg. § 1.148-5(d)(2) that it applies to purpose investments in all instances, or at a minimum clarifying the point in the preamble. With respect to nonpurpose investments, the clarification can be addressed by inserting the word "nonpurpose" before the word "investment" in the first sentence of the Reg. § 1.148-5(d)(3)(i) and clarifying the point in the preamble.

Clarify Interaction Between Reg. § 1.148-2(d)(2) and Reg. § 1.148-5(d)(3)

Current Reg. § 1.148-5(d)(2) is titled "mandatory valuation." Current Reg. § 1.148-5(d)(3) is titled "mandatory valuation," and current Reg. § 1.148-5(d)(3)(i) contains a lead-in stating "except as provided in paragraphs (d)(2) . . .," and contains the words "must be valued." The interplay of Reg. § 1.148-2(d)(2) and Reg. § 1.148-5(d)(3) under the Existing Regulations is unclear and subject to alternative interpretations.

The Proposed Regulations (i) include a new cross-reference to Reg. § 1.148-5(b)(3) and Reg. § 1.148-5(d)(3) in revised Reg. § 1.148-5(d)(2), (ii) delete the reference to Reg. § 1.148-5(d)(2) in Reg. § 1.148-5(d)(3)(i) and (iii) the preamble to the Proposed Regulations interprets the Transferred Proceeds/Universal Cap Exception (as such term is defined in Section 4 (Summary of Existing Regulations) below) as the *sole* exception[17] to application of the fair

have a yield different from the yield on the conduit issuer's tax-exempt bonds. A fair market valuation requirement would be particularly troubling to issuers of state revolving fund bonds, which make loans to governmental entities with proceeds of tax-exempt bonds on a subsidized basis. Such loans are often made on a taxable basis. At times, the loans are pledged to a tax-exempt state revolving fund bond issue well after such loans are originated. To require a purpose investment to be valued at fair market value when the bond issuer is intentionally providing a below-market interest rate on the investment would run entirely contrary to the purpose of the special yield rules on purpose investments.

[16] Under the ambiguity in the Existing Regulations created by the cross-reference in Reg. § 1.148-5(d)(3)(i) to § 1.148-2(d)(2), such investments have been valued at present value, or par if they are plain par investments. Under the Proposed Regulations, the cross-reference in Reg. § 1.148-5(d)(3)(i) to § 1.148-2(d)(2) is removed, suggesting that perhaps Reg. § 1.148-5(d)(3) is intended to take precedence over Reg. § 1.148-5(d)(2) even for purpose investments. The purpose investment in the above state revolving fund example will necessarily have a fair market value below its present value or par value since the loan is a subsidized loan (it is designed to have an interest rate below the market interest rate on origination). A fair market valuation requirement could cause yields on the purpose investments to exceed the permitted spreads of 1/8% or 1.5%, which is an untenable (and presumably unintended) result.

[17] The preamble states that the "Existing Regulations include only *one* exception to this mandatory fair market value rule." The existing regulations state "[e]xcept as provided in (d)(2), (d)(3)(ii), and (d)(4) of this section …." and thereby indicate that there are at least three exceptions. The Proposed Regulations state "[e]xcept as provided in (d)(3)(ii), and (d)(4) of this section …." and thereby indicate that there are two exceptions. We recommend that IRS more clearly articulate the number and nature of the exceptions in the preamble for the next set of regulations.

market valuation requirement of Reg. § 1.148-5(d)(3)(i). Nevertheless, the mandatory valuation title to Reg. § 1.148-5(d)(2) is retained. Additionally, the final sentence of Reg. § 1.148-5(d)(2) is removed in the Proposed Regulations. The preamble to the Proposed Regulations did not make mention of the inclusion of the new cross-reference and did not make mention of the removal of the cross-reference or the removal of the last sentence. Both the Existing Regulations and the Proposed Regulations create confusion. It is unclear whether one regulatory provision is intended to trump the other or they are intended to apply in a mandatory fashion but to different factual situations.

We recommend that IRS (1) clarify how the two "mandatory rules" interplay (if at all) or clarify the different circumstances to which each is to apply, and (2) state why the cross-reference to Reg. § 1.148-5(d)(2) and the final sentence of Reg. § 1.148-5(d)(2) is proposed to be removed. For example, if Reg. § 1.148-5(d)(2) is intended to apply to purpose investments and Reg. § 1.148-5(d)(3) is intended to nonpurpose investments, the point should be clarified/specified in language of the regulations and/or the preamble to the next version of the regulations.[18]

3. Additional Requests

We also request that the following provisions be added to the final valuation regulations.

<u>Effective Date</u>

If the fair market valuation rule, at least as applied to yield restricted investments, was inconsistent with the policies behind the arbitrage rules on September 16, 2013, the rule was also inconsistent with such policies from the date of its adoption. As an alternative to the effective date clarification described in Section 2 (<u>Effective Date</u>) above, the changes in the valuation rules should be completely retroactive at the election of the issuer.

<u>Extend Valuation Rule to Apply to Redemption with Equity Funds</u>

For the same policy reasons that IRS should not provide disincentives for the redemption of tax-exempt bonds with taxable bonds, it should not provide disincentives for the redemption of tax-exempt bonds with equity. The following text in bold and underscore is a specific change to Reg. § 1.148-5(d)(3)(ii) for this purpose:

> Paragraph (d)(3)(i) of this section does not apply if the investment **<u>(A)</u>** is allocated from one issue to another as a result of the transferred proceeds allocation rule under §1.148-9(b) or the universal cap rule under §1.148-6(b)(2), provided that the issue from which the investment is allocated (that is, the first issue in an allocation from one issue to another) consists exclusively of tax-exempt bonds**<u>, or (B) ceases to be allocated to an issue in connection with the issuer using amounts that are not proceeds of an obligation to redeem tax-exempt bonds prior to maturity</u>**. In addition, paragraph (d)(3)(i) of this section does not apply to investments in a commingled fund (other than a bona fide debt service fund)

[18] See also the discussion above addressing purpose investments.

unless it is an investment being initially deposited in or withdrawn from a commingled fund described in §1.148-6(e)(5)(ii).

Extend Valuation Rule to Address Deallocations Other than by Operation of the Transferred Proceeds Rule and the Universal Cap Rule

Circumstances may arise whereby nonpurpose investments deallocate by means other than the transferred proceeds rule or the universal cap rule (*e.g.*, amounts can be deallocated by no longer being treated as replacement proceeds). For example, assume the taxable bonds described in Example 2 above are issued on Day 1 and the tax-exempt bonds are defeased on Day 1 with taxable bond proceeds but redeemed on Day 30. The escrow securities would no longer be replacement proceeds of the tax-exempt bonds on Day 1 by operation of Reg. § 1.148-6(b)(1) because they are no longer used in a manner that causes those amounts to be replacement proceeds of the tax-exempt bonds, *i.e.*, as a result of the defeasance on Day 1. Since they are not deallocated as a result of either the transferred proceeds rule or the universal cap rule, the fair market exception in the Proposed Regulations would not apply. The same policy considerations that justify an exception to the fair market value rule for deallocations as a result of transferred proceeds and universal cap also apply to deallocations as a result of the replacement proceeds rule. We recommend that the proposed valuation rule be modified to accommodate this circumstance by eliminating the requirement that the allocation from the tax-exempt bond issue to the taxable issue occur as a result of either the transferred proceeds allocation rule or the universal cap rule.

Alternatively, since securities pledged to the repayment of a bond issue will have been replaced by the proceeds of the taxable bond issue, such securities, by virtue of the general definition of replacement proceeds in Reg. § 1.148-1(c)(1),[19] will become replacement proceeds of the taxable bonds. Proposed Reg. § 1.148-5(d)(3)(ii) could be modified to change "as a result of the transferred proceeds allocation rule under §1.148-9(b) or the universal cap rule under §1.148-6(b)(2)" to "as a result of the transferred proceeds allocation rule under §1.148-9(b), the universal cap rule under §1.148-6(b)(2), or the replacement proceeds rule under §1.148-1(c)(1)."

Safe Harbor for Application of Anti-Abuse Authority

The opportunity to capture market gain is often an economic incentive for issuers to retire tax-exempt bonds early. Without such an incentive, many issuers will not have an economic reason to act to unburden the market via the early retirement of tax-exempt bonds. These issuers will only consider an early retirement of already defeased tax-exempt bonds if a liquidation of the escrow securities subsequent to tax-exempt bond redemption is permitted.[20] Even if all of

[19] Reg. § 1.148-1(c)(1) provides in part that "amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose." Since the defeasance securities were to be used for the governmental purpose of the taxable bonds had the taxable bonds not been issued, they will therefore have a sufficiently direct nexus to the taxable bonds to be characterized as replacement proceeds of the taxable bonds (even if they were not immediately deposited into a sinking fund for, or otherwise pledged to, the taxable bonds).

[20] To further the policy of unburdening the market via the early redemption of tax-exempt bonds, some practitioners believe that the valuation rules should be modified to enable the issuer to simply liquidate the escrow securities,

the suggestions regarding the scope of the present value rule contained in these comments are adopted, some bond counsel may be concerned that, if a subsequent liquidation of the escrow securities occurs too close in time to the redemption of the tax-exempt bonds, IRS will be able to assert its authority under Reg. § 1.148-10 to depart from the rules of Reg. § 1.148-5(d) and recompute the yield on the escrow securities based on fair market value methodology. Additionally, issuers and bond counsel may take different positions on this issue (*i.e.*, allow different periods of time). The regulations should provide certainty and uniformity in practice. Uncertainty as to the facts and circumstances pursuant to which IRS may take such a position could be a substantial obstacle to unburdening the market via the early redemption of already defeased tax-exempt bonds. Accordingly, we propose that the following example be added to the final regulations [first paragraph is identical to the example set forth in Section 2 (<u>Application of Universal Cap Rule in the Context of Equity-Funded Escrows</u>) above, and is included only for ease of reference]:

(i) *In 2002, City X issues tax-exempt bonds to finance eligible costs. In 2006, City X used non-borrowed funds (*i.e.*, equity) to purchase escrow securities and create an escrow restricted to the yield on the tax-exempt bonds and defease the tax-exempt bonds to maturity. The yield on the tax-exempt bonds is 5.00% and the yield on the escrow securities is 4.95%. The early call option(s) on the tax-exempt bonds are retained by City X. In 2013, City X issues taxable bonds with a comparable maturity structure to the outstanding 2002 tax-exempt bonds and uses a portion of the proceeds to redeem the tax-exempt bonds on the same date. Only $100 of taxable bonds is needed to retire the tax-exempt bonds, but the escrow securities would provide sufficient cash flow to support $115 of taxable bonds. City X issues $115 of taxable bonds, and $100 of the proceeds are used to retire the tax-exempt bonds and $15 of the proceeds are used for any lawful purpose of City X. At the time of issuance of the 2013 taxable bonds, the escrow securities have a fair market value that, if sold, would cause the yield on the escrow securities to exceed the yield on the 2002 tax-exempt bonds. Applying universal cap principles, at the time the 2002 tax exempt bonds are redeemed, the escrow securities cease to be allocated as replacement proceeds of the tax-exempt bonds and, because they are used thereafter to secure the repayment of the taxable bonds, they become replacement proceeds of the taxable*

utilize proceeds from the sale of the escrow securities to call the tax-exempt bonds, and to enable the issuer to retain excess sale proceeds from the escrow securities. In order to do this, the valuation regulations would need to be modified to allow for the escrow securities to be valued at present value, not fair market value, even in the event of this actual disposition. While we see the policy reason that some are advocating for such a rule, we acknowledge that section 148(f)(4)(A)(i) (" In determining the aggregate amount earned on nonpurpose investments for purposes of paragraph (2)-- (i) any gain or loss on the disposition of a nonpurpose investment shall be taken into account") may preclude IRS from adopting such a rule in the context of an actual disposition of nonpurpose investments, although arguably such rule can be interpreted to apply solely to unrestricted nonpurpose investments for rebate purposes and not apply to yield restricted nonpurpose investments.

bonds. At the time the escrow securities cease to be allocated to the tax-exempt bonds, the escrow securities are valued at present value.

(ii) The result would be the same in each of the following circumstances:

a. Instead of issuing taxable bonds in an amount in excess of the amount required to redeem the tax-exempt bonds, the escrow securities are liquidated after a substantial period has passed after liquidation of the tax-exempt bonds. For this purpose, a substantial period is generally determined based on all facts and circumstances but, in all events a substantial period is deemed to have passed if the pricing and liquidation of the escrow securities occurs at least 90 days[21] *after the redemption of the tax-exempt bonds.*

b. Instead of issuing taxable bonds with a comparable maturity structure to the outstanding 2002 tax-exempt bonds, City X issues taxable bonds with a 90-day term. Upon maturity of the taxable bonds, City X liquidates the escrow securities and uses a portion of the liquidation proceeds to repay the taxable bonds and uses the remaining liquidation proceeds for any lawful purpose of City X.

Furthermore, to the extent that an early redemption of tax-exempt bonds is necessary for valid business reasons wholly apart from arbitrage motivations, it does not seem appropriate to assert an arbitrage anti-abuse rule. Accordingly, we request that IRS adopt a safe harbor that provides that, if the redemption of the tax-exempt bonds is undertaken as a remedial action pursuant to Reg. § 1.141-12 as set forth in our Example 1 above, an issuer need not separate the pricing and liquidation of the escrow securities and the related redemption of tax-exempt bonds by any period of time. Moreover, we request that the preamble to the final regulations note that the examples proposed above are merely safe harbors and, to the extent that a non-arbitrage purpose exists for either of the transactions described above, it may not be necessary for the period of time between tax-exempt bond redemption and escrow liquidation to be as long as set forth in the above examples.

[21] Because the value of securities fluctuates daily as interest rates change, there is risk every day that any appreciation in value of escrow securities will be diminished or eliminated. To the extent that IRS is concerned with blessing transactions that are motivated solely by arbitrage opportunities, even a relatively small required gap between tax-exempt bond redemption and escrow liquidation will be meaningful. In this context, we believe that a 90-day safe harbor is suitably conservative and the IRS should consider a 15-day safe harbor, by analogy to the single issue rule in Reg. § 1.150-1(c)(1)(i). Nonetheless, if IRS is not comfortable providing a safe harbor of 15 days or 90 days, we ask that it provide a longer safe harbor in the interest of clarity, as opposed to no safe harbor at all.

Exception to Fair Market Value Rule for Investments Acquired in Anticipation of Yield Restriction

Transactions occasionally occur wherein the bond issuer knows at the time a nonpurpose investment is purchased that it will be allocated as gross proceeds of a particular tax-exempt bond issue on a future date. The issuer may buy United States Treasury Securities—State and Local Government Series ("SLGS") in such cases to assure that the yield restriction associated with the anticipated gross proceeds allocation will be met. In fact, the SLGS rules set forth in 31 CFR Part 344 specifically allow this.[22] A future mark-to-market requirement applicable to the SLGS investment at the time it becomes gross proceeds of tax-exempt bonds would put the issuer in the untenable situation of not knowing whether yield on the investment from and after the valuation date will exceed the yield on the bonds and, accordingly, the issuer is unlikely to proceed with the transaction.

The following example illustrates the transaction. An issuer issues 20-year tax-exempt advance refunding bonds in 2010. All proceeds of this tax-exempt advance refunding bond issue are spent by 2013 when the advance refunded bonds are retired. The 2010 tax-exempt bonds are callable at par in 2020. In 2014, the issuer issues taxable advance refunding bonds to refund the 2010 tax-exempt bonds, which are not eligible for a tax-exempt advance refunding. The taxable bonds mature in 2018 (and the escrow established with the taxable bonds expires in 2020, the call date of the refunded 2010 tax-exempt bonds). Once the taxable bonds mature, the universal cap causes the "released proceeds" of the taxable bonds to become replacement proceeds of the 2010 tax-exempt refunded bonds. Although the 2014 escrow investments (*e.g.*, SLGS) may at the time of purchase be properly restricted to the yield on the 2010 tax-exempt bonds, in anticipation of the 2018 reallocation, the yield based on fair market value of the investments in the escrow established with the taxable bonds in 2018 will not be known until 2018. The issuer would need to wait and take remedial action (presumably a yield reduction payment but, if such a payment is not available, an investment or escrow modification) on or after the reallocation date if the adjusted yield on the SLGS is greater than the yield on the 2010 tax-exempt bonds.

Under the Existing Regulations, the concern created by the above fact pattern is substantially mitigated by Reg. § 1.148-5(d)(6)(i), which provides that "[t]he fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury is its purchase price." While this rule may have been primarily created to ensure that SLGS are always deemed to be purchased at fair market value, the current regulation by its terms goes well beyond that limited application. In effect, it provides that the fair market value of SLGS is always par because SLGS are always purchased for par under the provisions of 31 CFR Part 344. The current rule, however, does not completely solve the problem highlighted above because open market securities are sometimes used for portfolios expected to be yield restricted in the future (particularly when SLGS are not available for purchase).

The Proposed Regulations limit the application of the "fair market value is par" rule to the time of acquisition. In other cases the Proposed Regulations would provide that the fair market value is the redemption value. We understand the desire to treat redeemed SLGS as redeemed at fair market value. However, using a hypothetical redemption value for SLGS (even if well defined) is usually inappropriate. Most SLGS are purchased for refunding or defeasance

[22] 31 CFR § 344.1 (see definition of *eligible source of funds).*

escrows.[23] An issuer does not have unlimited freedom to redeem such SLGS and profit by an increase in value. Such SLGS generally can only be redeemed if other investments that continue to meet the escrow requirements are substituted. Moreover, the SLGS regulations for many years have prohibited the reinvestment amounts derived from an early SLGS redemption (whether in additional SLGS or in other investments) at a yield higher than the yield to maturity of the redeemed SLGS based on the redemption value.[24] Thus the effective fair market value of SLGS redeemed prior to maturity is less than the redemption value; even if the Bureau of Fiscal Service (successor to the Bureau of Public Debt) is willing to pay 108% of par to the SLGS investor, few SLGS investors would find that there was any benefit to such a liquidation.

To solve the problem, without creating an opportunity for abuse, the mark-to-market requirement of Reg. § 1.148-5(d)(3) could be amplified to provide the following exceptions.

(iii) Exception to fair market value requirement for investments acquired in anticipation of yield restriction. Paragraph (d)(3)(i) of this section does not apply to a nonpurpose investment if at the time of purchase the yield on the nonpurpose investment is computed to be not materially higher than the yield on a bond issue to which the issuer anticipates the nonpurpose investment will be subsequently allocated.

(iv) Exception to fair market value requirement for amounts invested in SLGS. Paragraph (d)(3)(i) of this section does not apply to a nonpurpose investment if the nonpurpose investment is purchased directly from the United States Treasury.

4. Suggested Reordering and Simplification

Summary of Existing Regulations

Under the Existing Regulations, the valuation rules are set forth in Reg. §§ 1.148-5(b)(3), and 1.148-5(d)(1) through 1.148-5(d)(6). Although not clear in all instances, and in some cases inconsistent, the current rules addressing valuation can be summarized by reference to the following table.

[23] A small number of SLGS are purchased for unrestricted project funds, debt service reserve funds or bona fide debt service funds. Such SLGS are purchased for those accounts because (a) such amounts are permitted to be invested in SLGS, (b) SLGS are safe investments, (c) SLGS are easy to purchase without involving a broker, and (d) the yields on SLGS is relatively comparable to other investments. While the restrictions involved in escrowed securities may not apply to such SLGS, the restrictions on reinvestment of redemption proceeds does apply.

[24] Before 2005, SLGS investors could profit from market value fluctuations. SLGS were at times redeemed at a profit and reinvested in higher yielding SLGS to meet the escrow requirements. However, the 2005 (current) SLGS regulations ended this practice.

Source of Funds Allocated To/Away from Tax-Exempt Bonds	Restricted Nonpurpose Investments[25]	Unrestricted Nonpurpose Investments
Equity to Tax-Exempt	FMV	FMV
Taxable to Tax-Exempt	FMV	FMV
Tax-Exempt to Tax-Exempt	Present Value	Principal Amount, PV, or FMV
Tax-Exempt to Equity	*Unclear*	FMV
Tax-Exempt to Taxable	*Unclear*	FMV

Under current Reg. § 1.148-5(d)(2), any yield restricted investment must be valued at present value. Under Reg. § 1.148-5(d)(3)(i), and subject to the exception in the following sentence, an investment must be valued at fair market value on the date the investment is first allocated to an issue and on the first date an investment ceases to be allocated to an issue. The preamble to the Proposed Regulations interprets the Existing Regulations as requiring an investment to be marked-to-market when the investment shifts between proceeds of a tax-exempt and a taxable bond issue, in either direction. This approach is sometimes referred to as a two-directional or bi-directional approach. Under Reg. § 1.148-5(d)(3)(ii), the above general rule does not apply if the investment is allocated from one issue to another issue as a result of a transferred proceeds allocation under Reg. § 1.148-9(b) or the universal cap rule under Reg. § 1.148-6(b)(2) <u>*provided*</u> that both issues consist exclusively of tax-exempt bonds (the "Transferred Proceeds/Universal Cap Exception").

<u>Summary of Proposed Regulations</u>

Under the Proposed Regulations, the Transferred Proceeds/Universal Cap Exception would be modified to provide that the exception applies if the issue away from which the investment is allocated consists exclusively of tax-exempt bonds (*i.e.*, the first issue in an allocation from one issue to another). The modification to the Transferred Proceeds/Universal Cap Exception can be very helpful, particularly if the effective date is clarified as described above. The proposed rules addressing valuation can be summarized by reference to the following table.

Source of Funds Allocated To/Away from Tax-Exempt Bonds	Restricted Nonpurpose Investments	Unrestricted Nonpurpose Investments
Equity to Tax-Exempt	FMV	FMV
Taxable to Tax-Exempt	FMV	FMV
Tax-Exempt to Tax-Exempt	Present Value	Principal Amount, PV, or FMV
Tax-Exempt to Equity	FMV	FMV
Tax-Exempt to Taxable	Present Value,[26] FMV	Present Value

[25] Restricted nonpurpose investments are most commonly found in advance refunding escrows, sinking funds and other funds holding replacement proceeds. Unrestricted nonpurpose investments are most commonly found in project funds, debt service reserve funds and current refunding escrows.

[26] Provided within the Transferred Proceeds/Universal Cap Exception.

Suggested Reordering and Simplification

We believe that the valuation regulations can be clarified and simplified in several respects. Before setting forth our proposed reordering and simplification changes, however, we reiterate the points made in Section 2 (Clarify Valuation Treatment of Purpose Investments) that purpose investments should always be valued at present value, and in Section 3 (Extend Valuation Rule to Apply to Redemption with Equity Funds) that the valuation rules applied in connection equity redemptions of tax-exempt bonds should be the same as those applied in connection with taxable refundings of tax-exempt bonds.

We also would note that, generally, return on investments is attributable to the return of principal, investment earnings (*i.e.*, interest)[27] and gain (or loss) on sale attributable to market value appreciation (or depreciation). In the tax-exempt bond area, arbitrage is generally thought of as investment earnings (*i.e.*, interest) in excess of the yield on the subject tax-exempt bonds. Also, pursuant to section 148(f)(4)(A)(i), "any gain or loss on the disposition of a nonpurpose investments shall be taken into account." While this provision requires gain or loss on actual disposition of nonpurpose investments to be taken into account for purposes of calculating rebate, there is clearly more flexibility to determine whether deallocation of nonpurpose investments to a tax-exempt bond issues should be treated as a constructive disposition of the investment at fair market value. Absent some abuse, we do not believe that it should be necessary to value yield restricted investments at fair market value when they are deallocated from a bond issue.[28] To treat an investment as yield restricted when it is first allocated to an issue subjects the investment to the arbitrage rules and often artificially forces the investment to be below market (*e.g.*, if an issuer, in a 5% market environment, is required to yield restrict the investment to 4.25% percent, such investment's value is artificially lowered through the use of lower yielding SLGS). To require a yield restricted investment to be subsequently valued at fair market value has the potential to create distorting economic results unrelated to any arbitrage return to the issuer and runs contrary to sound tax policy.

Moreover, for reasons beyond the acknowledged impediments such a rule creates with respect to the issuance of taxable refunding bonds, a mark-to-market requirement for yield restricted nonpurpose investments operates in a manner that is entirely contrary to the objectives of the arbitrage rules.[29] If market gain on yield restricted nonpurpose investments can be used to

[27] Issuers do not typically invest gross proceeds in equity securities (*e.g.*, stock).

[28] We understand that the bi-directional mark-to-market requirement for yield restricted investments was added to the regulations to address possible abuses when investments are allocated (under transferred proceeds rules) from proceeds of a taxable bond issue to proceeds of a tax-exempt bond issue. A present value method of valuation could in such case allow a transferred investment to be valued for yield restriction purposes at a value higher than the total amount of principal and interest paid on taxable debt used to acquire the investment. Such potential for abuse does not exist in using the present value of an investment when investments are allocated away from tax-exempt bonds.

[29] Application of the fair market valuation rule to yield restricted investments in the context of a constructive disposition arising from a deallocation of investments under the transferred proceeds, universal cap or replacement proceeds rules can allow issuers to take advantage of the spread between taxable and tax-exempt yields and penalize issuers who have book gains that are the result of market interest rate movements but that are not the result of the tax-exempt to taxable spread. To illustrate these points, assume advance refunding tax-exempt bonds are issued at an arbitrage yield of 3%. The refunding escrow is invested at 3% (in an assumed 3.50% taxable market) while a debt service reserve fund is invested at the 3.50% market rate. If rebate liability

facilitate the removal of tax-exempt interest from the market, the result should be encouraged by the regulations since doing so provides an appropriate incentive to "unburden" the tax-exempt bond market. We recommend that this issue be addressed by providing that yield restricted nonpurpose investments be valued at present value when deallocated from a tax-exempt bond issue. If IRS has concerns with such a provision/rule, we recommend that the concern be addressed in anti-abuse rules (for example, a provision could be included stating that if market gain is realized and tax-exempt bonds are taken off the market, it would be an abuse to subsequently refinance such bonds in the future in the tax-exempt market).

The suggested reordering and simplification changes can be summarized by reference to the following table:

Source of Funds Allocated To\Away from Tax-Exempt Bonds	**Restricted Nonpurpose Investments**	**Unrestricted Nonpurpose Investments**
Equity to Tax-Exempt	FMV	FMV
Taxable to Tax-Exempt	FMV	FMV
Tax-Exempt to Tax-Exempt	Present Value	Principal Amount, PV, or FMV
Tax-Exempt to Equity	Present Value	FMV
Tax-Exempt to Taxable	Present Value	FMV

To accomplish the above result, Reg. §§ 1.148-5(b)(3), 1.148-5(d)(2), and 1.148-5(d)(3) can be replaced with the suggested provisions set forth below; and §§ 1.148-5(d)(4) through 1.148-5(d)(6) can be re-numbered as §§ 1.148-5(d)(7) through 1.148-5(d)(9).

Suggested Reg. §§ 1.148-5(d)(1) through 1.148-5(d)(6):

1.148-5(d)(1) In General. *Insert existing Reg. §1.148-5(d)(1), which sets forth the three valuation approaches (outstanding principal amount, present value, and fair market value).*

1.148-5(d)(2) Purpose Investments. A purpose investment shall be valued at its present value at all times.

1.148-5(d)(3) Mandatory Valuation of Certain Investments at Fair Market Value. Except as provided in paragraphs (i), (ii) and (iii) below, a nonpurpose investment shall be valued at fair market value on the date that it is first allocated to a tax-exempt issue (either by purchase or deemed acquisition).

(i) A nonpurpose investment allocated from one tax-exempt issue to another

is computed at the end of the first computation period, the issuer would owe rebate equal to the excess earnings on the reserve fund, which is all of the arbitrage that has been earned. If, however, the fair market valuation rule were to be applied on that same date by reason of a deallocation, and assuming that the fair market values of the escrow and reserve fund securities are the same as on the date of original purchase, the escrow securities would be valued at a loss (since the 3% rate on the refunding escrow is below the 3.5% market rate). That constructive loss would offset the positive arbitrage on the reserve fund securities, allowing the issuer to retain some or all of the positive arbitrage on the reserve fund investments. If the taxable market had significantly rallied to a yield of 2% on the escrow securities, application of the fair market valuation rule in connection with any deallocations would treat the gain on the escrow securities as illicit arbitrage, notwithstanding the fact that the gain is totally attributable to the difference between the arbitrage yield of 3% and market yields of 2% and no portion is attributable to the spread between taxable and tax-exempt yields (*i.e.*, 3.50% v. 3%).

tax-exempt issue shall be valued at its present value on the date of such allocation.

(ii) A nonpurpose investment shall be valued at present value on the date first allocated to a tax-exempt issue if at the time of original purchase the yield on the nonpurpose investment was computed to be not materially higher than the yield on the bond issue to which the issuer anticipated the nonpurpose investment would be subsequently allocated and to which the nonpurpose investment is in fact allocated.

(iii) A nonpurpose investment shall be valued at present value upon allocation to a tax-exempt issue if the nonpurpose investment was purchased directly from the United States Treasury.

1.148-5(d)(4) Nonpurpose Investments Held Beyond Temporary Period. For purposes of section 1.148-2, at the end of a temporary period provided under 1.148-2(e), a nonpurpose investment may be valued under any of the three valuation methods of paragraph (d)(1).

1.148-5(d)(5) Yield Restricted Nonpurpose Investments. A yield restricted investment shall be valued at its present value when it ceases to be allocated to a tax-exempt issue.

Example:

*(i) In 2002, City X issues tax-exempt bonds to finance eligible costs. In 2006, City X used non-borrowed funds (*i.e.*, equity) to purchase escrow securities and create an escrow restricted to the yield on the tax-exempt bonds and defease the tax-exempt bonds to maturity. The yield on the tax-exempt bonds is 5.00% and the yield on the escrow securities is 4.95%. The early call option(s) on the tax-exempt bonds are retained by City X. In 2013, City X issues taxable bonds and uses a portion of the proceeds to redeem the tax-exempt bonds on the same date. The amount of taxable bonds that may be issued and supported by cash flows from the escrow securities exceeds the amount required to redeem the tax-exempt bonds and the excess proceed derived from the taxable bonds are used by City X for lawful governmental purposes. At the time of issuance of the 2013 taxable bonds, the escrow securities have a fair market value that, if sold, would cause the yield on the escrow securities to exceed the yield on the 2002 tax-exempt bonds. At the time the escrow securities cease to be allocated to the tax-exempt bonds, the escrow securities are valued at present value.*

(ii) The result would be the same if, instead of issuing taxable bonds in an amount in excess of the amount required to redeem the tax-exempt bonds, the escrow securities are liquidated after a substantial period has passed after liquidation of the tax-exempt bonds. For this purpose, a substantial period is generally determined based on all facts and circumstances but, in all events a substantial period is

deemed to have passed if the pricing and liquidation of the escrow securities occurs at least [90] days after the redemption of the tax-exempt bonds.

1.148-5(d)(6) Unrestricted Nonpurpose Investments. An investment unrestricted as to yield shall be valued at its fair market value on the date it ceases to be allocated to a tax-exempt issue. This paragraph (d)(6) does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is an investment being initially deposited in or withdrawn from a commingled fund described in section 1.148-6(e)(5)(iii).

D. *Anti-Abuse Provisions*

The Proposed Regulations modify Reg. § 1.148-10(e) by replacing the phrase "as necessary to clearly reflect the economic substance of the transaction" with the phrase "to prevent such financial advantage." The revised anti-abuse provision in the Proposed Regulations would permit IRS to ignore its own published regulations and other official public guidance if IRS believed that a transaction was entered into for a "principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148." The proposed change of standards separates potential arbitrage abuses from other tax law abuses. Read literally, this proposed provision appears to suggest that, even if a transaction were in compliance with published guidance, if the IRS thought that the transaction was entered into to achieve a financial advantage based on arbitrage, then IRS could ignore its own published guidance and impose whatever rule or standard it felt appropriate to prevent such financial advantage. The Existing Regulations limit the Commissioner's ability to depart from the published regulations by authorizing him or her to do so only in order to "clearly reflect the economic substance of a transaction". Reg. § 1.148-10(e) currently uses an economic substance standard that also applies in other areas of the tax law and has recently been codified as section 7701(o) of the Code. It does not provide that the Commissioner can create new rules if he or she does not like the application of the existing rules to a transaction; it does provide that the Commissioner can recast the form of the transaction to reflect the true economics of the transaction. Under the Existing Regulations, the recast transaction should still be subject to the provisions of the published regulations and not subject to whatever rule or standard that the Commissioner at that point thinks ought to apply.

The proposed deletion of the economic substance standard would change the current anti-abuse rule from a standard which provides that, if the economic substance of the transaction is different than the form of the transaction, then the form is recast to reflect economic substance if the form provides a financial advantage based on arbitrage; to a standard where, regardless of the economic substance of the transaction, if there is a financial advantage based on arbitrage, there is an abuse. We believe that this proposed extension of the Commissioner's authority is overly broad. We are unsure why IRS would want to deviate from an economic substance doctrine that is applied across all areas of federal tax law. Perhaps, this change is grounded in the peculiar legislation found in the Technical and Miscellaneous Revenue Act of 1988.[30] That legislation deleted and then re-inserted the word "necessary" in the provisions (now found in section 148(i) of the Code) providing the Commissioner with authority to promulgate arbitrage regulations. In the words of the Senate Finance Committee:

> This amendment is intended to clarify that the Treasury's regulatory authority is to be interpreted broadly, rather than in a literal, dictionary manner as was done by the Court of Appeals in the City of Tucson case [(*City of Tucson v. Commissioner*, 820 F.2d 1283 (D.C. Cir., 1987))]. That regulatory authority is intended to permit Treasury to eliminate any devices designed to promote the issuance of bonds either partially or wholly as investment conduits in violation of the provisions adopted by Congress to control such activities and to limit the issuance of tax-exempt bonds to amounts actually required to fund the activities for which their use specifically has been approved by Congress. Further, that regulatory authority is intended to permit Treasury to adopt rules (including allocation, accounting and replacement rules) necessary or appropriate to accomplish the purpose of the arbitrage restrictions, which is to eliminate significant arbitrage incentives to issue more bonds, issue bonds earlier, or to leave bonds outstanding longer.[31]

If IRS is determined to use a special standard for imposing anti-abuse rules not applicable to other areas of tax law (including other areas of tax-exempt bond law), then the standard adopted should be modeled on the 1988 legislative history of the provision authorizing such regulations. If such deviation from standard tax principles is to be followed, the standard should be to eliminate significant arbitrage incentives to issue more bonds, issue bonds earlier, or leave bonds outstanding longer. However, we believe that Congress never intended that arbitrage regulations provide that published guidance under arbitrage provisions should be ignored merely because IRS were to determine that there is a financial advantage based on the difference between tax-exempt and taxable rates. For example, it has been long understood that temporary-period arbitrage generally is <u>not</u> *per se* abusive; this change would allow IRS, at its whim, to make it so.

The proposed modification to Reg. § 1.148-10(e) also is a significant departure from prior anti-abuse authority asserted by the Commissioner. The preamble to the final 1992 arbitrage regulations[32] states the reason for, and the role of, the anti abuse rules as follows:

> 1. General anti-abuse rule.
>
> > The existing regulations contain numerous narrow, specific anti-abuse rules. In lieu of many of these narrow rules, the proposed regulations

[30] Pub. L. No. 100-647, 102 Stat. 3342.

[31] Senate Finance Committee Report Technical Corrections Bill of 1988, S.2238, August 3, 1988 at page 407,408.

[32] 1992-2 C.B. 688, FI-36-92.

> provide a broad, general anti-abuse rule that treats bonds as taxable arbitrage bonds if the issuer uses an abusive device to obtain a material financial advantage based on arbitrage. This general anti-abuse rule replaces the general artifice or device rules contained in §1.103-13(j) and §1.148-9(g) and numerous specific anti-abuse rules. The application of this general abusive device rule is broader than the existing rules but is also intended to treat as arbitrage bonds all transactions and actions covered by these various existing anti-abuse rules.

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P. Simplification and enforcement.

> An important part of the simplification of the existing arbitrage regulations involves the elimination of narrow anti-abuse rules targeted to specific abusive transactions. In large measure, the proposed regulations replace these specific rules with more general rules on abusive devices and specific guidance on replacement proceeds.
>
> The complexity of existing regulatory guidance on arbitrage restrictions, however, is in part attributable to statutory and regulatory responses to abuses. Permanent simplification in this area depends on the effectiveness of the proposed regulations, particularly the proposed general anti-abuse rules. Effective enforcement is an important component of this simplification effort. In furtherance of these goals, IRS is actively studying the enforcement procedures developed in the tax-exempt bond area. Related goals are building on increased enforcement in recent years and increasing voluntary compliance. ***Primary goals are the prompt examination of potentially abusive transactions and prompt published guidance on significant abusive transactions. In addition, this project may lead to legislative or other initiatives to reduce the difficulties currently encountered in examining tax-exempt bond transactions***. [Emphasis added.]

Note that, although the 1992 final regulations introduced a broad anti-abuse approach instead of the more specific anti-abuse approaches taken in Reg. § 1.103-13(j) and Reg. § 1.148-9(g), the 1992 final regulations did not go so far as to say that IRS could ignore application of the regulations for transactions that it deemed "abusive." The preamble to the 1992 final regulations addressed transactions that complied with the Existing Regulations but which IRS deemed to abusive by providing for the prompt publication of guidance to address "significant abusive transactions." We agree that IRS has an interest in prohibiting abuse of the arbitrage rules, but not by injecting uncertainty into the application of previously published guidance. Bond counsel traditionally renders an unqualified opinion with respect to whether obligations qualify for exemption under section 103. This unqualified opinion standard requires a high level of certainty as to the ability to rely on published guidance from IRS and Treasury. We believe that the proposed modifications to Reg. § 1.148-10(e) would seriously lower the level of certainty with respect to reliance on published guidance.

The existing anti-abuse rules suggest that the Commissioner can ignore the published rules to the extent necessary to reflect the economic substance of the transaction. Based upon the lead-in to the change in the Proposed Regulations, we believe that Treasury and IRS intend to leave intact all but the heading and the first sentence of Reg. § 1.148-10(e). Given the nature of this provision, examples are very valuable in clarifying the meaning of the provision and should be retained as part of the provision.

For the reasons stated above, NABL suggests that the proposed amendment be withdrawn and that Reg. § 1.148-10(e) not be modified. In the alternative, we suggest that the language in Prop. Reg. § 1.148-10(e) be modified as follows:

> (e) Authority of the Commissioner to prevent transactions that are inconsistent with the purpose of the arbitrage rules. If an issuer enters into a transaction for principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of §§1.148-1 through 1.148-11 as necessary to **reflect the economics of the transaction** to prevent such financial advantage. **Any transaction recast in this manner will then be subject to §§1.148-1 through 1.148-11.** For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148. [Changes shown in bold.]

APPENDIX I
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APPENDIX II

OUTLINE OF TOPICS TO BE DISCUSSED
AT THE PUBLIC HEARING ON
PROPOSED REGULATIONS IRS REG - 148659-07
ARBITRAGE RESTRICTIONS ON TAX-EXEMPT BONDS
FEBRUARY 5, 2014, 10:00 AM
THE NATIONAL ASSOCIATION OF BOND LAWYERS

I. The proposed definition of "issue price" is not required or appropriate to address the policy objectives and stated concerns of Treasury and IRS. (3 minutes)

A. The preamble to the proposed regulations, the proposed definition of "issue price" in the proposed regulations and public comments made by Treasury and IRS officials after publication of the proposed regulations emphasize that the amendments to the issue price definition are intended to make that definition more consistent with current regulations under sections 1273 and 1274 of the Code, which implies that such consistency, including an "actual sales" approach, is required by the cross-reference to sections 1273 and 1274 in section 148(h) of the Code. A review of the history and purpose of the arbitrage statutes and regulations, including the existing regulations, confirms that an "actual sales" approach is not required.

B. In the preamble to the proposed regulations, Treasury and IRS also state that the significant amendments to the issue price definition would "address [certain] concerns" and "provide greater certainty." As discussed below, NABL believes that the proposed definition is not administrable by issuers and, therefore, will result in less certainty. The concerns described in the preamble generally relate to the manner in which municipal securities are offered and distributed, and imply that the conduct of municipal underwriters is sometimes inappropriate and perhaps illegal. Concerns about the offering and distribution process for municipal securities should be addressed by working with municipal securities regulators, not through tax policy. Treasury and IRS should share their concerns with the Securities and Exchange Commission, the Municipal Securities Rulemaking Board and the Financial Industry Regulatory Authority and request that they investigate and take appropriate regulatory and enforcement action.

II. The proposed definition of "issue price" is not administrable by issuers under existing law and market practices. (4 minutes)

A. The proposed definition of "issue price" is not administrable by issuers because issuers and bond counsel do not have access to the information necessary to determine issue price based on actual sales to the "public" as defined under the proposed regulations.

B. The proposed definition of "issue price" also is not administrable by issuers because it does not assure that the issue price of publicly offered municipal bonds can be determined as of the sale date. To be administrable by issuers, any definition of "issue price" of publicly offered municipal bonds must enable issue price to be determined as of the sale date, when the terms of the issue are established. Determination of issue price as of the sale date is important for three reasons.

i. Issuers may violate applicable State law, policy or authorizing resolutions if issue price cannot be determined as of the sale date.
ii. Because compliance with numerous other provisions of federal tax law depends on the determination of issue price, issuers may unintentionally violate those provisions if issue price cannot be determined as of the sale date.
iii. Finally, bond counsel must confirm on the sale date whether they can give an unqualified approving opinion at closing.

III. Attempts to comply with the proposed definition of "issue price" will impose substantial additional expense on issuers and alter longstanding practices in the municipal market. (3 minutes)

A. If the proposed definition is adopted and municipal bonds continue to be marketed in ways that result in unsold maturities on the sale date, issuers will bear substantial additional expense attempting to determine issue price based on actual sales to the public.

B. To eliminate unsold maturities on the sale date in negotiated underwritings, issuers would be forced to accept lower prices and higher yields.

C. Because issuers may not be able to eliminate the possibility of unsold maturities in competitively sold deals, the ability of issuers to sell bonds competitively may be limited.