National Association of Bond Lawyers

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December 11, 2014

Internal Revenue Service
CC:PA:LPD:PR (REG-148659-07)
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: REG-148659-07—Supplemental Comments Regarding Valuation of Purpose Investments

Ladies and Gentlemen:

The National Association of Bond Lawyers (NABL) respectfully submits the enclosed comments regarding the valuation of purpose investments. These comments were prepared by an ad hoc task force comprising those individuals listed in Exhibit B and approved by NABL's Board of Directors. These comments supplement NABL's submission to the Internal Revenue Service on December 16, 2013, relating to the valuation of investments under proposed arbitrage regulations published in the Federal Register on September 16, 2013 (REG-148659-07).

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

If NABL can provide further assistance, please do not hesitate to contact Bill Daly in our Washington, D.C. office at (202) 503-3300.

Sincerely,

Antonio D. Martini
Enclosure

SUPPLEMENTAL COMMENTS BY THE NATIONAL ASSOCIATION OF BOND LAWYERS REGARDING THE VALUATION OF PURPOSE INVESTMENTS UNDER THE PROPOSED ARBITRAGE REGULATIONS PUBLISHED ON SEPTEMBER 16, 2013

The following comments are submitted on behalf of the National Association of Bond Lawyers (NABL) and supplement NABL's comments submitted on December 16, 2013, regarding the proposed arbitrage regulations published in the Federal Register on September 16, 2013 (REG-148659-07) (the "Proposed Regulations"). These comments provide additional input regarding the valuation of purpose investments under the Proposed Regulations.

Valuation of Purpose Investments at Present Value

NABL believes that the consensus view of its membership under the Existing Regulations[1] is that purpose investments are properly valued at present value at all times. In our view, tax policy and practical considerations pertaining to purpose investments require that such an approach continue to apply under any successor to the Existing Regulations.

Typically, purpose investments are acquired by issuers to provide financing at below-market rates to qualified borrowers; the intention in doing so is to carry out governmental programs and objectives.[2] The most common purpose investment is a conduit loan, which is a loan acquired by an issuer of tax-exempt bonds to carry out a qualified purpose. Conduit loans typically mirror the tax-exempt bonds from which they are generated in terms of amounts borrowed and debt service, providing conduit borrowers with below-market rates. Since conduit loans themselves generally are not tax-exempt obligations, as discussed in detail below, they have fair market values that are necessarily below the prices at which they are acquired by conduit issuers.[3] A requirement that purpose investments be valued at fair market value upon allocation to a bond issue would generally cause the loan yield to exceed the related bond yield and would therefore limit the ability of issuers to finance purpose investments. No federal tax policy goal would be served by such a requirement.

The Existing Regulations are consistent with the policy that purpose investments be valued at present value. Treas. Reg. § 1.148-5(d)(2) states that "[a]ny yield restricted investment must be valued at present value. For example, a purpose investment . . . must be valued at present value." The fair market value rule of Treas. Reg. § 1.148-5(d)(3)(i) exempts investments

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[1] On June 18, 1993, the Treasury Department and the Internal Revenue Service published comprehensive final regulations (T.D. 8476, 1993-2 C.B. 13) on arbitrage investment restrictions and related requirements 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, these final regulations have been amended in limited respects. The regulations issued in 1993 and the amendments thereto are collectively referred to herein as the "Existing Regulations."

[2] Purpose investments include loans made with the proceeds of qualified 501(c)(3) bonds, qualified mortgage bonds, qualified veterans' mortgage bonds, qualified student loan bonds, exempt facility bonds and qualified small issue bonds.

[3] In the case of bond banks and other pooled financings, including state revolving fund bond issues, conduit loans are intentionally originated with interest rates that are below the tax-exempt interest rates on the bond issue, providing an even deeper subsidy to the borrowers, in furtherance of the issuer's governmental objectives.

valued under Treas. Reg. § 1.148-5(d)(2) from valuation at fair market value by providing that "*[e]xcept as provided in [paragraph 1.148-5](d)(2)*, . . . an investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition." (Emphasis added).

Relevance of Present Value Rule

Any future regulations under Code § 148 should retain the rule that purpose investments are valued at present value. The present value approach is particularly compelling in this context for the reasons described below.

Purpose investments "deliver" the benefit of tax-exempt financing to borrowers. A purpose investment is defined as "an investment acquired to carry out the governmental purpose of an issue."[4] Purpose investments are the means by which the economic benefits of tax-exempt financing are transferred to the borrower in a conduit financing (most frequently to nongovernmental persons such as 501(c)(3) organizations or qualified mortgage loan, qualified veterans' mortgage loan or qualified student loan borrowers).[5] Purpose investments are not typically styled as tax-exempt obligations and are not typically acquired by reference to any objective fair market value standard. Instead, they are acquired principally to facilitate the carrying out of governmental purposes. To require that purpose investments be valued at fair market value would inhibit the ability to pass the benefit of tax-exempt financing to the ultimate borrowers. The following example illustrates the differing outcomes under the arbitrage bond rules when valuation of a purpose investment is permitted at present value and when valuation of a purpose investment is mandated at fair market value.

Assume a $20 million financing for a 501(c)(3) organization in a 4% taxable interest rate environment when the comparable tax-exempt yield is 3.3%. The cash flows for this example are included in Exhibit A. The issue price and present value of the purpose investment (the conduit loan) is $20 million based on this 3.3% yield. If regulations were to require the purpose investment to be valued at fair market value, that fair market value would equal the present value of the cash flows using the 4% market interest rate as the discount factor. To simplify this fair market value calculation, Exhibit A assumes a bond that matures in 20 years and has a single maturity, with respect to which the issuer charges an issuance fee of $359,838 (just under 0.125%). The fair market value of the cash flows discounted at 4% using these assumptions is approximately $18,085,116. Fair market valuation affects the financing as follows:

(a) The 0.125% permitted spread of Treas. Reg. § 1.148-2(d)(2)(i) cannot be satisfied. In some interest rate environments, the 1.5 percent spread limitation for "program investments" under Treas. Reg. § 1.148-2(d)(2)(iii) also would not be satisfied.

[4] Treas. Reg. § 1.148-1(b).

[5] Less frequently, purpose investments arise in the context of conduit financings by an issuer for other governmental entities (*e.g.*, a pooled financing by a state issuer such as a bond bank or state revolving fund for the benefit of local governmental units). While purpose investments in this context can be structured as tax-exempt obligations, we understand that the prevailing practice is to structure such purpose investments as taxable obligations because of the cost and administrative burden of qualifying such investments as tax-exempt investments.

This will happen whenever market spreads between tax-exempt and taxable borrowing rates exceed 1.5 percent.[6]

(b) The $1,914,884 difference between the present value of $20 million and the fair market value of $18,085,116 represents the present value economic benefit of tax-exempt financing. Of this difference, $359,838 represents the issuer fee and $1,555,046 represents the value of the tax-exemption subsidy being passed through to the borrower.

(c) For a fixed yield bond, yield is determined as of the issue date. Giving effect to fair market value in respect of the purpose investment would eliminate the predictability of establishing and passing through to the conduit borrower the fixed tax-exempt cost of borrowing on that date.

(d) Without access to the tax-exempt market, the conduit borrower would borrow from a bank at the assumed taxable rate of 4 percent. Using the same repayment schedule and a 4% yield, this would mean that the conduit borrower would be able to borrow only $18,085,116 for its governmental purpose and not the needed $20 million that would be available in the tax-exempt market if present valuation were used.

Lack of an established market to value purpose investments. There is no readily ascertainable market to establish the fair market value of purpose investments because purpose investments generally are not negotiable instruments. Without an established market, fair market valuation becomes highly speculative, presenting substantial practical difficulties for determining value. Issuers would be put to considerable administrative burden and cost to obtain such valuations. Due to the lack of established markets, there would also be a risk that similar purpose investments of different issuers would be given different values. In terms of fair administration of the tax laws, this should be of concern to the Internal Revenue Service.

Distorting economic results. Purpose investments are often used to make loans to local government entities and to other qualified borrowers, including qualified mortgage loan, qualified veterans' mortgage loan and qualified student loan borrowers, on a subsidized basis, particularly to borrowers that have difficulty accessing the market. For example, a state agency may issue tax-exempt bonds at 4% and use the proceeds to make loans to municipalities at 4%. These municipalities may not have the necessary credit quality to borrow in their own right at a 4% rate on the open market and may face market resistance to their illiquid, small-volume issues. The tax-exempt market rate for these municipalities may be substantially higher than the 4% rate the state agency can provide. Investors are willing to buy the state agency's 4% bonds, however, because, in addition to pledging the 4% loans made to the municipalities, the issuer also pledges built-up reserve funds, or federal funding for clean water, transportation or similar programs. The value of the rate differential between the state agency's 4% borrowing rate and the municipality's higher borrowing rate is distinct from the subsidy inherent in tax-exempt financing, and the transfer of the value of this rate differential is an appropriate governmental

[6] The same would be true in the context of qualified mortgage bonds and qualified student loan bonds, but under Code § 143(g)(2)(A) and Treas. Reg. § 1.148-2(d)(2)(iv), the spread limitations would be 1.125 percent and 2 percent, respectively.

objective. If valuation at fair market value were required, the economic results would be distorted because the tax rules would be driving an economic result contrary to the state and local government objective of allowing state agencies to provide subsidized loans to borrowers that have difficulty accessing the market.[7] Such a result runs contrary to sound tax policy and frustrates state and federal policy relating to, among other programs, programs for clean water, transportation and affordable housing.

Fundamental nature of tax-exempt debt and chilling effect on market. The Internal Revenue Service has indicated that valuations are typically done at fair market value for general federal income tax purposes, and that the use of an alternative approach would need to be justified. For the reasons noted above, the tax-exempt financing area is different than other areas of the tax law requiring valuations. It is an appropriate state and local government objective for an issuer to make below-market loans with the proceeds of tax-exempt bonds. A fair market value rule would not be administrable, would ignore the fact that the loan is taxable while the underlying bonds are tax-exempt, and would limit the ability of a state or local government to make subsidized loans. Accordingly, adoption of a fair market value rule for purpose investments could have a chilling effect on the tax-exempt market and the viability of conduit borrowers to borrow for needed projects.

Purpose Investments and Replacement Proceeds

We understand that the Internal Revenue Service is concerned with the valuation of purpose investments when sale proceeds and investment proceeds of tax-exempt bonds are not used to acquire the investments that are pledged to the bond issue.[8] The purpose investments in these cases constitute “replacement proceeds” of the bond issue within the meaning of Treas. Reg. § 1.148-1(c). The question is whether an investment acquired with an issuer’s unrestricted funds should be treated, and continue to be treated, as a purpose investment when it is pledged to a tax-exempt bond issue, or whether there are circumstances in which such an investment should cease to be treated as a purpose investment of the issue.

Assuming that an investment is initially acquired to carry out a proper governmental purpose of the issuer and continues to effectuate that purpose while it remains in the issuer’s portfolio, it seems fair to conclude that nothing has changed and the treatment of the investment should not be different under the arbitrage rules simply because the investment is allocated from the issuer’s “equity” to a bond issue, de-allocated from a bond issue or reallocated from one bond issue to another bond issue serving the same governmental ends. A mortgage to a low-income first-time homebuyer is still a mortgage to a low-income first-time homebuyer. A conduit loan to a political subdivision continues to have the same governmental purpose before

[7] Other examples of this type of distortion are found in the qualified student loan and qualified mortgage loan areas. Borrowers of qualified student loans benefit from programmatic credit support and from repayment terms that are typically not offered by for-profit lenders, resulting from federal support under Higher Education Act or a variety of state subsidies. Borrowers of qualified mortgage loans similarly benefit from these types of efficiencies and from federal housing-related programs such as the Treasury Department’s recent New Issue Bond Program.

[8] An example would be the pledging of mortgage investments acquired with a housing agency’s unrestricted funds for the benefit of the holders of bonds issued to finance mortgages to other low-income homebuyers through an issue of qualified mortgage bonds under Code §143. The pledged investments typically will be deposited in a reserve or pledge fund established by the issuer with respect to the qualified mortgage bonds.

and after a de-allocation or reallocation, and a conduit capital lease financing to equip a 501(c)(3) hospital is still such a conduit capital lease to a 501(c)(3) hospital. The public policy objectives and the intended benefits of the financing continue after the reallocation to inure to the benefit of the borrower. Similarly, the treatment should not be different under the arbitrage rules simply because the investment was acquired with an issuer's unrestricted funds (equity) prior to the investment being pledged to a tax-exempt bond issue. There is no requirement in the Existing Regulations that an investment be funded with sale proceeds or investment proceeds of an issue in order to be allocated to that issue as a purpose investment, nor is there a public policy reason for doing so. It is only when the governmental purpose ceases to be served by an issue to which the investment is allocated and the borrower is no longer advantaged that it would make sense to stop treating the investment as a purpose investment.

The issue of whether and when an investment acquired with an issuer's unrestricted funds should be treated, or cease to be treated, as a purpose investment was not raised in the Proposed Regulations, nor were the attendant valuation requirements that should apply in those circumstances. Should the Internal Revenue Service consider changes or additional regulations on this question, NABL believes that such changes should be in the form of proposed regulations to provide notice to interested parties and an opportunity to comment.

One consideration in connection with any such proposed regulation is that the definition of purpose investment would need to be revisited. The definition in Treas. Reg. § 1.148-1 does not currently require that a purpose investment be funded with sale proceeds or investment proceeds of the subject tax-exempt bond. Similarly, program investments, which are a type of purpose investment, are not required to be funded with sale proceeds or investment proceeds of tax-exempt bonds.

Another consideration is that purpose investments and program investments are referred to in other substantive rules in the arbitrage regulations. Proposed changes to the existing framework for purpose investments should take into account the impact such changes would have on the other substantive provisions in the Existing Regulations. The following are just a few examples. Under Treas. Reg. § 1.148-5(b)(2)(ii), purpose investments and nonpurpose investments are separate classes of investments. Under Treas. Reg. § 1.148-6(b)(2), purpose investments are not subject to the universal cap (other than qualified student loans and qualified mortgage loans, which are treated as nonpurpose investments under the universal cap rules). Under Treas. Reg. § 1.148-9(h)(3)(i), each purpose investment is treated as a separate purpose, although, if the separate purpose investments are eligible for the same temporary period, the issuer may treat the separate purpose investments as a single purpose.

If a rule providing that either (1) an investment loses its character as a purpose investment and becomes a nonpurpose investment, or (2) an investment is not a purpose investment unless acquired with sale proceeds or investment proceeds is proposed, the impact of such change on the separate class rule, the universal cap rule and the separate purpose rule should be carefully evaluated. There are likely many other substantive rules in the arbitrage regulations that could be affected by changes to the existing framework for purpose investments. Moreover, as noted above, should such a change be considered, a practical issue will arise with regard to how to establish the fair market value of the investments in the absence of an established market.

EXHIBIT A

FAIR MARKET VALUE CALCULATION

Purpose Investment Example

Date	Bond Principal	Tax-Exempt Bond Rate	Bond Interest	Bond Debt/Service	Bond Issue Price	-1.799% Issuer Fee	Bond Yield 3.300% P.V Factor	P.V. at Bond Yield	Bond Yield Plus 1/8% 3.425% P.V Factor	P.V. at Bond Yield +1/8%	Taxable Yield 4.000% P.V Factor	P.V. at Taxable Yield
9/1/2014					($20,000,000)	$359,838	1.00000	($20,000,000)	1.00000	($19,640,162)	1.00000	
3/1/2015			$330,000	$330,000			0.98377	$324,643	0.98316	324,444	0.98039	$323,529
9/1/2015			330,000	330,000			0.96780	319,374	0.96661	318,981	0.96117	317,186
3/1/2016			330,000	330,000			0.95209	314,190	0.95034	313,611	0.94232	310,966
9/1/2016			330,000	330,000			0.93664	309,090	0.93434	308,331	0.92385	304,869
3/1/2017			330,000	330,000			0.92143	304,072	0.91860	303,139	0.90573	298,891
9/1/2017			330,000	330,000			0.90647	299,137	0.90314	298,035	0.88797	293,031
3/1/2018			330,000	330,000			0.89176	294,281	0.88793	293,018	0.87056	287,285
9/1/2018			330,000	330,000			0.87729	289,504	0.87298	288,084	0.85349	281,652
3/1/2019			330,000	330,000			0.86305	284,805	0.85828	283,234	0.83676	276,129
9/1/2019			330,000	330,000			0.84904	280,182	0.84383	278,465	0.82035	270,715
3/1/2020			330,000	330,000			0.83525	275,634	0.82963	273,777	0.80426	265,407
9/1/2020			330,000	330,000			0.82170	271,160	0.81566	269,167	0.78849	260,203
3/1/2021			330,000	330,000			0.80836	266,758	0.80192	264,635	0.77303	255,101
9/1/2021			330,000	330,000			0.79524	262,428	0.78842	260,180	0.75788	250,099
3/1/2022			330,000	330,000			0.78233	258,168	0.77515	255,799	0.74301	245,195
9/1/2022			330,000	330,000			0.76963	253,978	0.76210	251,492	0.72845	240,387
3/1/2023			330,000	330,000			0.75714	249,855	0.74927	247,258	0.71416	235,674
9/1/2023			330,000	330,000			0.74485	245,800	0.73665	243,095	0.70016	231,053
3/1/2024			330,000	330,000			0.73276	241,810	0.72425	239,002	0.68643	226,522
9/1/2024			330,000	330,000			0.72086	237,885	0.71205	234,978	0.67297	222,081
3/1/2025			330,000	330,000			0.70916	234,023	0.70007	231,022	0.65978	217,726
9/1/2025			330,000	330,000			0.69765	230,224	0.68828	227,132	0.64684	213,457
3/1/2026			330,000	330,000			0.68633	226,487	0.67669	223,308	0.63416	209,271
9/1/2026			330,000	330,000			0.67519	222,811	0.66530	219,548	0.62172	205,168
3/1/2027			330,000	330,000			0.66423	219,194	0.65410	215,852	0.60953	201,145
9/1/2027			330,000	330,000			0.65344	215,636	0.64308	212,218	0.59758	197,201
3/1/2028			330,000	330,000			0.64284	212,136	0.63226	208,645	0.58586	193,334
9/1/2028			330,000	330,000			0.63240	208,693	0.62161	205,132	0.57437	189,544
3/1/2029			330,000	330,000			0.62214	205,305	0.61115	201,678	0.56311	185,827
9/1/2029			330,000	330,000			0.61204	201,973	0.60086	198,282	0.55207	182,183
3/1/2030			330,000	330,000			0.60210	198,694	0.59074	194,944	0.54125	178,611
9/1/2030			330,000	330,000			0.59233	195,469	0.58079	191,662	0.53063	175,109
3/1/2031			330,000	330,000			0.58272	192,296	0.57101	188,435	0.52023	171,675
9/1/2031			330,000	330,000			0.57326	189,175	0.56140	185,262	0.51003	168,309
3/1/2032			330,000	330,000			0.56395	186,104	0.55195	182,143	0.50003	165,009
9/1/2032			330,000	330,000			0.55480	183,083	0.54266	179,076	0.49022	161,774
3/1/2033			330,000	330,000			0.54579	180,111	0.53352	176,061	0.48061	158,602
9/1/2033			330,000	330,000			0.53693	177,188	0.52454	173,097	0.47119	155,492
3/1/2034			330,000	330,000			0.52822	174,311	0.51570	170,183	0.46195	152,443
9/1/2034	$20,000,000	3.300%	330,000	20,330,000			0.51964	10,564,332	0.50702	10,307,758	0.45289	9,207,262
	$20,000,000		$13,200,000	$33,200,000				$0.00		($0.01)		$18,085,116

In the above example, the issuer and borrower agree to an issuer fee of $ 359,837.92
An issuer fee of $360,000 or more would cause the arbitrage limit of 1/8% to be exceeded.
The issuer fee is the difference between the amount that the issuer gets from the sale of the bonds and the amount that borrower gets from the sale of the purpose investment.
Using the purchase price as the issue price of the bonds less the fee, the purpose investment yield is shown to be within 1/8% permitted yield spread.

Based on the market rate for taxable loans to this company, the above computes a deemed FMV acquisition price of the purpose investment.
The only way that tax-exempt bonds can be used for conduit deals is if the purchase price is allowed to be non-market.

EXHIBIT B

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