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March 2, 2015

Helen Hubbard
Associate Chief Counsel
Financial Institutions and Products
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: Comments on Advice Memorandum AM2014-009 Regarding Defeasance and Reissuance of Build America Bonds

Dear Ms. Hubbard:

The National Association of Bond Lawyers (NABL) respectfully submits the enclosed comments in response to Advice Memorandum AM2014-009 regarding the defeasance and reissuance of build America bonds. The enclosed comments were prepared by an ad hoc task force comprising those individuals listed in Exhibit A and approved by the NABL Board of Directors.

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) 503-3303.

Sincerely,

Antonio D. Martini

CC: John Cross III
James Polfer
Rebecca Harrigal

COMMENTS BY THE NATIONAL ASSOCIATION OF BOND LAWYERS ON ADVICE MEMORANDUM AM2014-009 REGARDING DEFEASANCE AND REISSUANCE OF BUILD AMERICA BONDS

The following comments are submitted on behalf of the National Association of Bond Lawyers (NABL) in response to Advice Memorandum AM2014-009 (the "Memorandum") prepared by the Office of Chief Counsel of the Internal Revenue Service and released on December 19, 2014. The Memorandum addresses the defeasance of build America bonds ("BABs") and concludes that the defeasance of BABs causes them to be treated as reissued. NABL believes that this conclusion is contrary to the plain language of the Treasury Regulations (the "Regulations") and the intended meaning of the regulatory exception from reissuance for legal defeasances of tax-exempt obligations, and does not take into account the special role of BABs as alternative municipal financing tools. NABL is particularly concerned that reissuance treatment even for short call escrows will be unexpected and disruptive to issuers and purchasers of BABs.

Disruption to Issuers and Purchasers of BABs

Issuers of BABs often have the right to redeem the bonds if tax credit subsidies payable to the issuer are reduced. Language for these redemption provisions varies considerably and can include the ability to call bonds in the event of a change to the statutory credit rate or in the event of federal budgetary sequestration, which may reduce the subsidies payable to issuers. When the redemption provisions apply to sequestration, the resulting terms of the redemption vary. Many bond documents allow redemption at par at any time after the sequestration reduction. Other documents provide for make-whole redemption which, in practice, may not provide a benefit to issuers.

We understand that, to date, only those bonds subject to redemption at par (or with a modest premium) have actually been redeemed early as a result of a sequestration call. The par call provision effectively provides an issuer with favorable results, considering that taxable and tax-exempt rates have fallen significantly since 2010. In a refinancing resulting from the call, an issuer is able to replace higher coupon BABs (even net of the interest subsidy) with debt that has lower rates.

Because the rate on a sequestered BAB is in almost every case in excess of current borrowing rates, an issuer will want to redeem its BABs as quickly as possible. This means that any escrow established in connection with the redemption will likely last only the required notice period (often 30 to 60 days). The reissuance result of the Memorandum means that the issuer may lose tax subsidy payments for this short period. The reissuance result, however, also has other impacts on the entire municipal financing market that are of fundamental concern.

For example, the reissuance result causes bondholders to realize gain or loss on BABs not only upon the final redemption of the bonds, but also upon defeasance. This may cause income to be shifted to different taxable years and, in any case, leads to burdensome tax compliance for holders of BABs.

An equally troubling aspect of the Memorandum is the potential confusion that arises in connection with short escrows. Short escrows that could be considered legal defeasances are frequently created in the normal course of a bond financing. For example, cash may be deposited with a bond paying agent a short period before the actual principal and interest payment is due. This type of short escrow gives rise to a number of questions. If, on December 15, an issuer deposits the full amount of principal and interest due on a bond on January 1 of the following year, would the bondholder be charged with income on December 15 (which the Memorandum suggests could be a date of a deemed sale or exchange) in addition to January 1? Does an information report need to be provided to the bondholder in connection with the deemed sale or exchange on December 15?

We believe these impacts are avoidable because, as we explain below, BABs are "tax-exempt bonds" based on the plain language and intent of the Regulations and qualify for the special reissuance provisions applicable to tax-exempt bonds as well as the general provisions for unilateral issuer options. We respectfully request that the Internal Revenue Service reconsider the analysis in the Memorandum in light of these comments.

BABs are Tax-Exempt Bonds Under the Regulations

BABs are "tax-exempt bonds" within the meaning of Treas. Reg. § 1.1001-3(f)(5)(iii). NABL believes the rationale given in the Memorandum for disregarding the plain language of the Regulations cannot be reconciled with the preamble to Treas. Reg. § 1.1001-3 (the "Preamble"). Modifications of Debt Instruments, 61 Fed. Reg. 32926, 32926-32930 (June 26, 1996).

For purposes of Treas. Reg. § 1.1001-3, a tax-exempt bond is "a State or local bond that satisfies the requirements of section 103(a)." Code Section 103(a) provides that "[e]xcept as described in subsection (b), gross income does not include any interest on a State or local bond." Code Section 103(b) sets forth exceptions to the general rule of Section 103(a) for private activity bonds that are not qualified bonds, arbitrage bonds and bonds not satisfying the requirements set forth in Code Section 149. Satisfaction of the requirements of Code Section 103(a) does not, however, ensure that interest on a bond is in fact excluded from gross income.

Code Section 54AA(d)(1)(A) defines a "build America bond" as any obligation (other than a private activity bond) if, among other requirements, the interest on such obligation would be excludable from gross income under Code Section 103 but for Code Section 54AA. Code Section 54AA(f)(1) provides that interest on BABs is included in gross income. Therefore, although a BAB must meet the requirements of Code Section 103(a), the interest on a BAB is included in gross income for federal income tax purposes.

<u>Special Rules for Tax-Exempt Bonds Under Treas. Reg. § 1.1001-3</u>

Tax-exempt bonds are afforded special treatment under the reissuance regulations, including for purposes of determining whether tax-exempt bonds are recourse or non-recourse obligations.

State and local governmental bonds (tax-exempt or taxable) are often difficult to accurately characterize as recourse or nonrecourse because state law defining what sources are available for payment is often complex. A bond that is payable from water revenue, for instance, could be a nonrecourse obligation of a municipality, or it could be a recourse obligation of the water system. A general obligation bond could, depending on state law, nevertheless be considered a nonrecourse obligation if the issuer is limited with regard to revenue sources that are available for payment (so called limited tax general obligation bonds). Moreover, there is no uniform standard of law among the states for determining whether a bond is recourse or nonrecourse, so an obligation that would be deemed as recourse in one state may be nonrecourse in another (or vice versa). To solve these problems, Treas. Reg. § 1.1001-3(f)(6) provides that tax-exempt non-conduit bonds are generally treated as recourse obligations for purposes of the reissuance regulations. One exception to this general rule, however, is a bond secured only by an escrow account containing U.S. Treasury obligations. Under the exception found in Treas. Reg. § 1.1001-3(f)(6)(ii)(C), a legally defeased tax-exempt non-conduit bond is treated as non-recourse.

Treas. Reg. § 1.1001-3(e)(5)(ii) provides that a modification that converts a recourse obligation into a nonrecourse obligation (or vice versa) is a significant modification. One example given of such a modification is a legal defeasance under which an issuer is relieved of all further obligations to make payment on the debt once sufficient cash and investments have been placed into an escrow to pay debt service on that debt. If, however, the modification results in a legal defeasance of a tax-exempt obligation, Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(1) concludes that there is no significant modification. This is, in effect, an exception to the rule in Treas. Reg. § 1.1001-3(f)(6)(ii)(C).

The Memorandum admits that the plain language of the Regulations supports treatment of BABs as tax-exempt bonds, but concludes that the purpose of Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(1) is not applicable to BABs. The Memorandum attributes the purpose of the exception for tax-exempt bonds to the need to protect the tax-exempt bondholder's tax treatment of interest on the bonds. Accordingly, the exception would be inapplicable to BABs. The Memorandum quotes one partial sentence from the Preamble ("a significant modification could 'result in bonds that were tax-exempt when issued ceasing to be tax-exempt bonds'") (Memorandum at 3 quoting the Preamble at 61 Fed. Reg. 32929) to support its conclusion. We believe that this is not an accurate reading of the Preamble. The Preamble, in fact, recites and then rejects this argument (made by commentators hoping to exclude tax-exempt bonds from all of the rules of Treas. Reg. § 1.1001-3). Instead, the Preamble goes on to explain that the actual reason for the special treatment of tax-exempt bonds is instead based on the premise that such treatment is necessary "to better coordinate the final regulations with municipal financing practices."[1]

This rationale applies to BABs in the same manner as it applies to tax-exempt bonds because municipal financing practices for BABs are in most ways the same as those for tax-exempt bonds. For example, to better coordinate with municipal practices, the treatment as recourse or nonrecourse should be no different for BABs than for tax-exempt bonds. A water

[1] 61 Fed. Reg. 32930.

revenue tax-exempt bond has the same revenue pledge as a water revenue BAB. To coordinate with municipal financing practices, a legal defeasance should be treated the same way for both types of municipal financings. Thus, the literal words of the Regulations (that BABs are tax-exempt bonds) are supported by the language of the Preamble and the desire of Treasury and the Internal Revenue Service to coordinate with existing practice.

Practices that Give Rise to Defeasance Escrows

Defeasance escrows are established with respect to BABs and tax-exempt bonds for the same reasons. Both types of bonds are subject to the rules of Treas. Reg. § 1.141-12(d) providing that certain private use may be remediated by the establishment of an escrow.[2] Both types of bonds are subject to the economic preference of an issuer to reduce its borrowing costs by refunding bonds with lower yielding bonds if markets cooperate. Since tax-exempt refunding bonds can be used to refund BABs and tax-exempt bonds, the conditions for refundings are often the same.

Many large BABs were designed to appeal to traditional purchasers of taxable corporate debt and be callable at any time with make-whole call provisions. However, many BABs (large and small) were marketed to traditional purchasers of tax-exempt local governmental debt, and thus borrowed call provisions (along with security provisions) from the tax-exempt market and have par calls applicable after a ten-year period of call protection. These differences do not follow a split based on tax treatment of interest on the bonds. In addition, just as many tax-exempt bonds provide for early redemption in the event interest is determined to be taxable, many BABs provide for early redemption without make-whole premiums in the event the federal subsidy is eliminated or reduced.

Consequences of Reissuance

A tax-exempt bond when reissued may become taxable. That, however, is not the only consequence to a bondholder for a reissuance. A bondholder that holds a reissued bond (whether tax-exempt or taxable) may experience a gain or loss (or realization of market discount) on the occurrence of a reissuance. For this reason, issuers generally do not wish to cause bonds (taxable or tax-exempt) to be reissued without the participation or acceptance of the reissuance by the bondholder. In fact, a defeased bond that is deemed to be reissued may have a deemed issue price in excess of the bondholder's basis in the bond, resulting in taxable gain to the holder.

Rationale of the Memorandum Applies to Bonds that are Taxable

As mentioned above, we believe the Memorandum incorrectly quotes from the Preamble to explain the special treatment of tax-exempt bonds under Treas. Reg. § 1.1001-3. This

[2] We note that section 7.2.3.1.2(3)(A) of the Internal Revenue Manual (IRM) states that a defeasance escrow may not be a possible remediation for a BAB because a legal defeasance may cause a reissuance. The statement is based on the same reasoning as the Memorandum but, unlike the Memorandum, does not distinguish between legal defeasance situations and other escrow circumstances, such as an economic defeasance. We are concerned that this section attempts to provide for a new substantive tax rule without following a formal review and public comment process.

rationale was not the rationale relied on by the authors of the regulations. If this rationale were true, however, we believe the rationale would nonetheless apply to taxable municipal bonds. The rationale is that bondholders should not suffer consequences (such as tax-exempt bonds becoming taxable) for actions over which the bondholders have no control. Clearly, holders of tax credit bonds such as qualified zone academy bonds would be in the same position as holders of tax-exempt bonds if actions of the issuer could terminate the tax credits to which the holders are entitled. Furthermore, a holder of any debt instrument (tax-exempt or taxable) might suffer tax consequences such as realization of gain upon an event that triggers a reissuance.

Change in Application of a Clear Regulation

The Memorandum concludes that the literal language of the Regulations should not be applied. That literal application of the definition of tax-exempt bond for purposes of Treas. Reg. § 1.1001-3 is supported by the purposes of the definition as presented in the Preamble. Treas. Reg. § 1.1001-3 was carefully drafted with input from the affected community after publication of proposed regulations. If the Internal Revenue Service intends to apply Treas. Reg. § 1.1001-3 in a manner inconsistent with the plain wording of the Regulations because the Internal Revenue Service believes that this regulatory language is not consistent with the purpose of the Regulations, then the Internal Revenue Service should propose an amendment to Treas. Reg. § 1.1001-3 and solicit comments from the affected community. The importance of this matter suggests that a change to the Regulations should not be made without the formal process of amending or withdrawing the Regulations.

Legal Defeasance

Many escrows established for BABs (or tax-exempt bonds) do not create the legal defeasance condition described in Treas. Reg. § 1.1001-3(e)(5)(ii)(A). That is because the issuer often will not find it necessary as a practical matter to be relieved from all liability to make payments on the debt instrument (including an obligation to contribute additional cash or securities to a trust if necessary to provide sufficient funds to meet all scheduled payments on the instrument). Whether the issuer seeks such relief is usually determined by the context and also depends on the provisions of legal documents and state law that were adopted well before the Memorandum. Such state law provisions may not distinguish between BABs and tax-exempt bonds.

The legal documentation for BABs concerning relief of issuer liability was generally copied from language applicable to tax-exempt bonds. Creating a distinction now could be highly prejudicial to certain issuers, even if most bond issuers are unaffected by the provision. Note that even without such relief, issuers effectively fulfill their payment obligations by depositing sufficient funds with a paying agent or escrow agent (so called "economic defeasance"). If escrows (especially short escrows) are invested in U.S. Treasury obligations designed to provide sufficient principal and interest to fully pay all amounts due on a bond, there is very little chance that the issuer will be required to make additional payments on deposits regardless of whether the issuer actually receives relief from a requirement to make sure the bondholder is paid.

Summary

NABL believes that the plain language as well as the intent of the Regulations suggests that BABs qualify as tax-exempt bonds for purposes of the reissuance regulations. For these reasons, NABL respectfully requests that the Memorandum be modified or withdrawn.[3] If further guidance is provided, such guidance should not distinguish between BABs and tax-exempt bonds and should indicate that the exercise of a unilateral issuer option is effective for avoiding a reissuance. In any event, such guidance should confirm that short escrows will not give rise to a reissuance. Although there is no bright line on how short an escrow should be to be disregarded, we recommend that a 90-day standard be used, which follows the statutory definition of a current refunding.

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[3] Modification or withdrawal is not likely to affect issuers that may have received inconsistent treatment in connection with legal defeasances of BABs considering that subsidies may be claimed even after the time limits described in Form 8038-CP have passed, as suggested in Program Manager Technical Advice PMTA 2014-4 (January 26, 2015).

Exhibit A

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