National Association of Bond Lawyers

PHONE 202-503-3300 601 Thirteenth Street, NW
FAX 202-637-0217 Suite 800 South
www.nabl.org Washington, D.C. 20005

President
RICHARD J. MOORE
SAN FRANCISCO, CA

President-Elect
TERI M. GUARNACCIA
BALTIMORE, MD

Treasurer
ANN D. FILLINGHAM
LANSING, MI

Secretary
JOSEPH E. SMITH
BIRMINGHAM, AL

Immediate Past President
DEE P. WISOR
DENVER, CO

Directors:

M. JASON AKERS
NEW ORLEANS, LA

MICHAEL G. BAILEY
CHICAGO, IL

VICTORIA N. OZIMEK
AUSTIN, TX

SARA DAVIS BUSS
PITTSBURGH, PA

STACEY C. LEWIS
SEATTLE, WA

CAROL J. MCCOOG
PORTLAND, OR

Chief Operating Officer
LINDA H. WYMAN
WASHINGTON, DC

Director of Governmental Affairs
JESSICA R. GIROUX
WASHINGTON, DC

November 25, 2019

Krishna Vallabhaneni
Tax Legislative Counsel
United States Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3044
Washington, DC 20220

CC:PA:LPD:PR (REG-118784-18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments Regarding Proposed Treasury Regulation § 1.1001-6 and Proposed Amendment to Treasury Regulation § 1.1275-2 Relating to Tax Consequences of the Transition to Use of Reference Rates other than Interbank Offered Rates

Ladies and Gentlemen:

The National Association of Bond Lawyers (NABL) respectfully submits comments with respect to Prop. Treas. Reg. § 1.1001-6 and the proposed amendment to Treas. Reg. § 1.1275-2 (the "Proposed Regulations") contained in REG-118784-18 relating to tax consequences of the transition to the use of reference rates other than interbank offered rates in debt instruments and non-debt contracts. NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. We submit these comments in furtherance of that mission.

These comments were prepared by a working group comprised of individuals listed in the attachment to the comments and were approved by the Board of Directors of NABL. If NABL can provide further assistance, please do not hesitate to contact Jessica Giroux, Director of Governmental Affairs in our Washington DC office, at (202) 503-3290 or at jgiroux@nabl.org.

Sincerely,

Richard J Moore
President, National Association of Bond Lawyers

NATIONAL ASSOCIATION OF BOND LAWYERS COMMENTS TO PROPOSED TREASURY REGULATION § 1.1001-6 AND PROPOSED AMENDMENT TO TREASURY REGULATION § 1.1275-2 RELATING TO TAX CONSEQUENCES OF THE TRANSITION TO REFERENCE RATES OTHER THAN INTERBANK OFFERED RATES

The National Association of Bond Lawyers (NABL) submits this letter in response to the request by the Treasury Department and the Internal Revenue Service for comments concerning "any complications under any section of the Code or existing regulations that may arise from the replacement of an IBOR with a qualified rate and that are not resolved" in Prop. Treas. Reg. § 1.1001-6 and the proposed amendment to Treas. Reg. § 1.1275-2 contained in REG-118784-18 (the "Proposed Regulations").[1]

NABL sincerely appreciates the efforts by the Treasury Department and the Internal Revenue Service to provide practical guidance that will address the reissuance concerns involving debt instruments and non-debt contracts arising from alterations and modifications to facilitate an orderly transition from interbank offered rates (IBORs). Guidance is of particular concern to municipal issuers of tax-advantaged debt instruments[2] and their borrowers and to parties to related interest rate hedges because a very large number of these instruments and contracts have interest rate provisions that are based on the London interbank offered rate (LIBOR). NABL recognizes that comprehensive regulations clearly establishing guidance applicable to the entire market relating to IBORs is an immense task that can only be facilitated by interaction with market participants. Towards that end, NABL offers the comments and recommendations set forth below. Specifically, this letter addresses the following matters:

I. The final regulations should continue the special consideration given to tax-advantaged bonds concerning reissuance that is reflected in existing Regulations and other Treasury Department guidance.

II. We recommend modifying the arm's length safe harbor to allow issuers to satisfy it as long as the parties are unrelated, negotiate at arms' length, and establish that the negotiations do not take into account changes in the issuer's credit quality since the issue date. We discuss the substantial equivalence test for establishing that a replacement rate constitutes a qualified rate, and we recommend adding a new safe harbor for "qualified tender bonds" that treats the replacement rate as part of the original terms of the bonds for purposes of IRS guidance regarding qualified tender bonds and a new safe harbor allowing for industry-wide standard rates and adjustments as qualified rates. We recommend allowing an issuer to satisfy the historic averaging safe harbor using only one data point and allowing further flexibility on the window during which the issuer can collect data points to satisfy

[1] 84 Fed. Reg. 53985, 54068 (Oct. 9, 2019).

[2] The term "tax-advantaged debt instruments" or "tax-advantaged bonds" as used in this comment letter is intended to have the same meaning as "tax-advantaged bonds" set forth in Section 1.150-1(b) of the Treasury Regulations (the "Regulations") and includes, for example, tax-exempt debt instruments, taxable debt instruments that provide for a federal tax credit to investors and taxable debt instruments that provide federal tax credits payable directly to issuers.

this safe harbor, and we provide further comments for adjusting and clarifying the proposed safe harbors in the context of tax-advantaged bonds.

III. We make recommendations regarding how to treat "one-time payments" under the rules and regulations affecting tax-advantaged bonds. In particular, we recommend allowing each party to use its own reasonable and consistently applied accounting method, and we recommend not treating the one-time payment as any form of gross proceeds of a tax-advantaged bond issue.

IV. We make recommendations regarding how to treat one-time payments with respect to interest rate hedges. In particular, we recommend allowing issuers to allocate one-time payments with respect to an interest rate hedge under any reasonable method, and we recommend that the one-time payment should not cause "super-integrated" hedges to be reissued for tax purposes.

V. We discuss the limit on multiples in determining whether a rate is a qualified floating rate and provide recommendations about how this rule should apply to tax-advantaged bonds, continuing the special treatment of tax-advantaged bonds under the regulations.

VI. We request that the Treasury Department clarify the application of the Proposed Regulations and final Regulations to alterations or modifications occurring before final Regulations are published to confirm that the "consistent treatment" requirement applies separately to each debt instrument and non-debt contract.

I. Special Reissuance Considerations for Tax-Advantaged Bonds

A reissuance for federal income tax purposes raises several considerations that are unique to tax-advantaged bonds. Perhaps the most significant of these considerations is that a reissuance generally requires a retesting of many or all of the tax rules applicable to such bonds at the time of the reissuance. These include rules for how to use proceeds and bond-financed property (for example, as set forth in Sections 141, 142 and 145 of the Code) and rules relating to investment of bond proceeds (including the yield restriction and rebate requirements in Section 148 of the Code). Because of these rules, a reissuance of tax-advantaged bonds commonly requires observing numerous formalities and obtaining opinions, which can be costly and cumbersome to issuers and borrowers. In certain cases, the retesting required by a reissuance may also result in the complete loss of the tax-advantaged status of the bond.

Existing published Treasury Department and Internal Revenue Service guidance has a long history of acknowledging these special considerations and sets forth flexible reissuance rules for purposes of the applicable eligibility requirements. For instance, Section 1.1001-3(f)(6) of the Regulations[3] sets forth special reissuance rules that apply only to certain types of tax-advantaged bonds, and existing Treasury Department guidance as well as Regulations proposed in

[3] Unless otherwise specifically set forth in this letter, references in this letter to regulatory sections are to sections of the existing Regulations or Proposed Regulations, as applicable to the particular context. References in this letter to the Code are to the Internal Revenue Code of 1986, as amended.

December 2018[4] address reissuance hurdles accompanying tax-advantaged bonds that are "qualified tender bonds," as further described in Part II of this letter.

In light of these special considerations, NABL recommends that the reissuance rules for tax-advantaged bonds in finalized Regulations should in no respect be stricter than the rules that apply to taxable debt. NABL further believes that it is appropriate to consider more flexible treatment for purposes of determining whether tax-advantaged bonds are eligible for relief from reissuance under finalized Regulations. The comments and recommendations offered below should be considered with these special considerations in mind.

II. Safe Harbors to Determine Substantial Equivalence

Under Section 1.1001-6(b)(2), a substitute rate is only treated as a "qualified rate" if the fair market value of the debt instrument or non-debt contract after the substitution of the rate (and any associated alteration or modification, as defined in Section 1.1001-6(a)(5)) is substantially equivalent to the fair market value of the debt instrument or non-debt contract before the substitution. The Proposed Regulations provide two safe harbors for determining fair market value: the historic averaging safe harbor and the arm's length safe harbor. The Proposed Regulations further provide that additional safe harbors may be published in the Internal Revenue Bulletin.

NABL appreciates the attempt in the Proposed Regulations to provide for flexibility in determining the qualified rate and acknowledges that the existing safe harbors are intended to facilitate application of the substantial equivalence test. NABL is concerned, however, that the safe harbors contain requirements that may be challenging to comply with in practice and unworkable in certain situations. NABL respectfully requests guidance and offers suggestions as to several aspects of the substantial equivalence test and its safe harbors.

a. Additional Safe Harbor for Qualified Tender Bonds

NABL is concerned that the historic averaging and arm's length safe harbors of the Proposed Regulations are inadequate to address the special reissuance considerations affecting tax-advantaged qualified tender bonds described in Part I above and, for that reason, recommends the addition of the safe harbor described below for these types of bonds.

A qualified tender bond typically is a bond with more than one interest rate period through maturity that bears interest during each such period in accordance with a market-based interest-rate setting mechanism described in the bond documents. At the end of each interest rate period, the bond is put to the issuer for remarketing either to the entity that held the bond prior to the put or to another purchaser. To comply with safe harbors from reissuance established specifically for these types of bonds in IRS Notices 88-130 and 2008-41, the terms of the qualified tender bond must require that the bond be purchased and resold at a price equal to par upon commencement of the new interest rate mode except in certain circumstances relating to conversions to a fixed interest rate for the remaining term of the bond to maturity.

[4] 83 Fed. Reg. 67677, 67701 (Dec. 31, 2018) (providing for Proposed Regulations Section 1.150-3).

There are numerous possible types of interest rate modes at which a qualified tender bond may bear interest. For example, an interest rate mode may provide that the bond bears interest based on a specified duration of LIBOR multiplied by a tax-exempt equivalence factor plus a fixed spread that is determined at the time of remarketing such that the bond can be remarketed at par. A possible interest rate mode may also provide for remarketing at any fixed interest rate for the applicable mode period that is determined at the time of remarketing to allow the bond to be remarketed at par.

The difficulty in applying the arm's length safe harbor to a qualified tender bond arises when the interest rate mode being altered to replace LIBOR is not the interest rate mode at which the bond currently bears interest. For example, the bond may be bearing interest at a rate based on the SIFMA index or a daily rate at the time of the alteration, with the LIBOR interest mode being only one of several other modes in which the issuer may remarket the bonds in the future. At the time of the alteration, there will be no parties with which the issuer will be negotiating, and so, the basic requirement of the arm's length safe harbor cannot be satisfied. The historic averaging safe harbor will in most cases not offer a solution. At the time the issuer concludes the alteration to replace the LIBOR reference rate, the issuer usually is not able to establish the multiplier or amount of the spread or make a conclusion about a one-time payment because some or all of these items must be determined at the time of remarketing to comply with the par remarketing requirement of IRS Notices 88-130 and 2008-41.

NABL points out that Section 1.1001-6(b)(2)(ii) requires the historic averaging safe harbor to be applied only on the date of the alteration or modification and not at the time when the new rate becomes effective (or on both dates), and NABL is of the view that the same timing is applied to the arm's length safe harbor and the general substantial equivalence test. NABL believes that the appropriate time for testing substantial equivalence is at the time the alteration is made and that it would be burdensome and inconsistent with the purpose of the Proposed Regulations to provide for a smooth transition from LIBOR if substantial equivalence were required to be tested at the time the replaced rate becomes effective. Express clarification in final Regulations on this point would be useful.

To address the problems described above with the arm's length safe harbor and the historic averaging safe harbor as applied to qualified tender bonds, NABL proposes that final Regulations include a third safe harbor. The third safe harbor would be specifically applicable to circumstances where the altered rate becomes effective upon a remarketing of bonds consistent with the requirements of IRS Notices 88-130, 2008-41 or the reissuance Regulations proposed in December 2018 relating to tax-advantaged qualified tender bonds. Such remarketing meets the substantial equivalent value test because the value of the remarketed bond is, by operation of the arm's length remarketing, established to be substantially the same as the value of the bond remarketed in a different permitted interest rate mode. NABL requests that final Regulations expressly state in this context that the replacement of an IBOR-referencing rate, or the addition of a fallback rate to an IBOR-referencing rate, will not be treated as a modification and will not cause such bonds to be treated as reissued for purposes of Sections 103 and 141 through 150 of the Code when an interest rate is converted. NABL believes final Regulations should expressly provide that the replacement of an existing IBOR-referencing rate with a qualified rate (and associated alterations) or the addition of a new fallback rate will be treated as part of the original terms of a

bond for purposes of IRS Notice 2008-41 and similar future published guidance and will not adversely affect the favorable treatment provided by such guidance.

b. Additional Safe Harbor for Industry-Wide Standard Rates and Adjustments

The Alternative Reference Rates Committee ("ARRC") published its Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes on April 25, 2019. In this report and in similar ARRC recommendations for other types of debt instruments, the ARRC recognizes that "SOFR is fundamentally different from LIBOR. SOFR is an overnight, secured, nearly risk-free rate, while LIBOR is an unsecured rate published at several different maturities (overnight/spot, one week, one month, two months, three months, six months and one year)." As a result, the ARRC paper proposed the use of a "term SOFR" which would be adjusted by adding or subtracting a spread adjustment, "intended to make the successor rate level more comparable to LIBOR." The ARRC proposed that the term SOFR rate and the primary spread adjustment would be selected or recommended by the Relevant Governmental Body.[5] "Although an ARRC-recommended spread adjustment does not exist today, the ARRC has agreed to make such a spread adjustment recommendation one of its goals."

In addition to the ARRC's efforts, the International Swaps and Derivatives Association ("ISDA") has, under the auspices of the Federal Reserve Bank of New York, been undertaking a similar effort with respect to transitioning interest rate swaps away from LIBOR. Although ISDA has not yet published its recommendations, NABL understands that ISDA is expected to propose replacement rates based on a backward-looking compound SOFR plus an applicable credit spread that would, similarly to ARRC's proposal, be endorsed in some manner by the Federal Reserve.

The Proposed Regulations intend to "broadly facilitate the transition away from IBORs" and "to facilitate an orderly transition in connection with the phase-out of IBORs and the attendant need for changes in debt instruments and other non-debt contracts to implement this transition."

In this regard, NABL observes that LIBOR-referencing interest rates for tax-advantaged bonds are often somewhat complex, largely because LIBOR needs to be adjusted not only for the credit of the issuer but also for the tax-advantaged status of the bond. Some interest rate formulas for tax-advantaged bonds adjust based on marginal tax rates and accordingly can change over time because of factors that do not apply to other IBOR-referencing rates. These additional factors may make application to tax-advantaged bonds of the fair market value equivalence test as set forth in the Proposed Regulations more difficult than for taxable debt.

NABL recommends that an additional safe harbor to the substantial equivalence test be provided and that such safe harbor look to forthcoming ARRC and ISDA LIBOR replacement rate determinations, with the goal of fully aligning the ARRC and ISDA fallback provisions and the intent underlying the Proposed Regulations. NABL believes the Proposed Regulations already contemplate a similar flexible and adaptable approach by permitting for the inclusion of future replacement rates announced by a central bank, reserve bank, monetary authority or similar

[5] "Relevant Governmental Body" means the Federal Reserve Board or the Federal Reserve Bank of New York, or a committee officially endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York or any successor thereto.

institution or as published in the Internal Revenue Bulletin.[6] Therefore, to harmonize the Proposed Regulations with these ARRC or ISDA publications, an issuer should be able to avail itself of a safe harbor if it simply replaces LIBOR with term or compound SOFR and applying the "Benchmark Replacement Adjustment"[7] as detailed in the ARRC definition thereof pursuant to clauses (1) and (2) thereof, or a similar spread adjustment made publicly available by the Relevant Governmental Body, or as set forth in the expected similar ISDA proposal. To create simplicity, an issuer that looks to the ARRC or ISDA determination of term or compound SOFR plus the Benchmark Replacement Adjustment in replacing LIBOR should not need to undertake a fair market value equivalence analysis as, ostensibly, ARRC or ISDA will undertake such an analysis prior to announcing a Benchmark Replacement Adjustment. Therefore, a SOFR-based replacement utilizing the ARRC or ISDA defined replacement rates should be considered a qualified rate without the necessity of undertaking a fair market value equivalence test.

c. Historic Averaging Safe Harbor: Number of Data Points

When applying the "reasonable method" of computing historic average, the Proposed Regulations do not require that any particular number of data points be included. The term "average" is generally defined in the Merriam-Webster dictionary to be a single value that summarizes or represents the general significance of a set of unequal values. The Proposed Regulations do not expressly address whether the historic averaging safe harbor requires more than one data point.

By comparison, Section 1.1001-3(e)(2)(ii) states that a modification is not significant (and therefore there is no reissuance) if a rate is modified in a manner that results in a change in yield on the obligation that is no more than the greater of 25 basis points or 5% of the annual yield of the unmodified instrument. The change in yield is determined by comparing the rates (or, in the case of variable rate debt instruments (VRDIs), fixed rate substitutes for the rates) at the time of the modification. Thus, although substituting a qualified rate for an IBOR-related rate in a debt instrument might constitute a modification under the existing Regulations, there would not generally be a reissuance under this section of the Regulations if the interest rates are within 25 basis points solely at the time of the modification (representing only one data point). Although the Proposed Regulations allow more flexibility in determining an average over the time chosen by the parties, the existing Regulations appear to provide for a simpler computation, taking into account only one data point. NABL would appreciate confirmation of this interpretation that only one data point is required for establishing an average under the historic averaging safe harbor.

d. Historic Averaging Safe Harbor: Minimum Recency of Data Points

The Proposed Regulations permit the historic averaging safe harbor's 25 basis point test to be satisfied through application of a reasonable method of determining historic average rates that differs from any industry standard method that may be established so long as the applied method

---

[6] See, Prop. Treas. Reg. § 1.1001-6(b)(1)(ix) and (xii).

[7] Clauses (1) and (2) of the ARRC definition provide as follows: (1) the spread adjustment, or method for calculating or determining such spread adjustment (which may be a positive or negative value or zero) that has been selected or recommended by the Relevant Governmental Body for the applicable Unadjusted Benchmark Replacement; (2) if the applicable Unadjusted Benchmark Replacement is equivalent to the ISDA Fallback Rate, then the ISDA Fallback Adjustment.

meets certain requirements, including that it take into account all relevant rate values published during a continuous period ending no earlier than three months prior to the alteration or modification in question. Issuers that are able to select and to implement an alternative reference rate without independent third-party action or approval (*i.e.*, by getting the consent of only the other party to the debt or non-debt contract), should be able to easily comply with this requirement. However, this may not be the case for issuers that must preliminarily seek approval for such a change from a third party, such as an independent state entity that approves entry into, or amendment of interest terms of, debt instruments or other contracts, or for issuers whose debt obligations finance loans or other assets that produce LIBOR-based payments that cannot be unilaterally altered by the issuer. Such issuers may be in the position of being unable to identify an appropriate alternative reference rate until third-party action occurs. At least some issuers in this situation may find it difficult or impossible to begin the process of substituting an alternative reference rate until publication of the applicable LIBOR rate ceases. In such a case, it is possible that the three-month recency requirement may prove too limited for some issuers. NABL would suggest that this be addressed by slightly modifying this requirement to provide that the continuous sequence of published rates to be given effect must end "no earlier than three months before the earliest of (x) the date upon which publication of the applicable IBOR-based rate ceases, (y) December 31, 2021 or (z) the date of the alteration or modification."

e. Historic Averaging Safe Harbor: One-Time Payment

NABL is concerned that it is not clear under the Proposed Regulations how a one-time payment is to be factored into the computation for determining whether the historic average of the two rates is within 25 basis points. A similar problem arises under the existing arbitrage Regulations relating to tax-advantaged bonds. A one-time payment should be amortized over the remaining life of the debt instrument or other instrument using the yield on the issue taking into account the substitute rate (and adjustments). However, NABL believes that clarification would be helpful to determine whether this is an intended interpretation of the Proposed Regulations.

f. Arm's Length Safe Harbor: Definition of Related Party

The threshold requirement of the arm's length safe harbor is that the parties to the debt instrument or non-debt contract must not be related within the meaning of Sections 267(b) or 707(b)(1) of the Code. NABL suggests that, with respect to an arrangement involving a governmental unit or a 501(c)(3) organization, the unrelated party requirement should refer to the definition of "related party" in Section 1.150-1(b). In nearly all transactions involving tax-advantaged obligations and related non-debt contracts, governmental units and often 501(c)(3) organizations will be parties to such transactions. The provisions of Sections 267(b) or 707(b)(1) of the Code apply principally to corporate and partnership relationships and do not address the special characteristics of control that may exist among governmental units and 501(c)(3) organizations. Those characteristics of control are addressed by the controlled group concept contributed by the definition of related party in Section 1.150-1(b). For example, in Section 1.1001-6(b)(2)(ii)(B), the relationship reference in the first sentence might be rewritten to state as follows: ". . . related (within the meaning of section 267(b) or section 707(b)(1)) or related parties (if in reference to a governmental unit or a 501(c)(3) organization) . . ."

g. Arm's Length Safe Harbor: Requirement for a Determination

The preamble to the Proposed Regulations states that the permitted alterations are intended to be "generally no broader than is necessary to replace IBOR in the terms of a debt instrument." Section 1.1001-6(a)(4) states that, as an example, if an interest rate is otherwise increased "to account for deterioration in the issuer's credit since the issue date," the "risk premium" generally should be analyzed under Section 1.1001-3.

A requirement of the arm's length safe harbor is that the parties must make a determination as to the fair market value of the debt instrument or non-debt contract. NABL is concerned that the need for a formal determination may significantly compromise the usefulness of this safe harbor to the municipal market.

One practical hurdle of the safe harbor is that parties may be unable or unwilling to certify as to the fair market value of the debt instrument, particularly when the "substantially equivalent" standard is unclear. For example, issuers may lack expertise to conclude whether the value of a debt instrument is a fair market value. Professionals hired to provide such determination may be faced with difficulty in ascertaining market values where the debt instrument or non-debt contract is not actively traded or the debt instrument or non-debt contract otherwise has particular features that are difficult to value. The determination requirement also imposes additional burdens on state and local government as issuers and holders will need to retain experts, including legal counsel, to assist in documenting equivalence. Especially in a transaction where there are no new funds, governmental issuers may not have readily available sources to pay these unexpected expenses.

NABL suggests that the arm's length safe harbor can be significantly simplified without discounting the purpose of the substantial equivalence test by providing, in the alternative, that the requirement for a determination can be satisfied by relying solely on the arm's length negotiation between unrelated parties as long as the parties also certify that the arm's length negotiations were not intended to reflect changes in the issuer's credit since the issue date. Such a negotiation inherently reflects a fair market valuation because the negotiation is founded on economics incorporated into the debt instrument at the time of the modification and on each party's self-interest to maintain such economics. Fair market value of property is generally defined as the price at which the property would change hands between a willing seller and a willing buyer,[8] and in an exchange for other property in an arm's length transaction, the properties being exchanged are generally presumed to be of equal value.[9]

III. Treatment of One-Time Payment with Respect to Debt Instruments

Under the Proposed Regulations, an "associated alteration" taken in conjunction with substitution of a qualified rate for an IBOR-based rate will not be treated as a modification. An associated alteration includes "the obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate to offset the change in value of the debt instrument" that results from that replacement. The one-time payment may be made either by the holder or the issuer of the debt instrument. NABL requests clarification

---

[8] See, e.g., Treas. Reg. § 1.170A-1(c)(2).
[9] See, e.g., C.G. Meaker Co., Inc. v. Comm'r, 16 T.C. 1348.

on how such one-time payment is to be treated under the requirements for tax-advantaged bonds and offers the considerations and suggestions below.

a. One-Time Payment Received by Holder

Under the Proposed Regulations, for all purposes of the Code, the source and character of a one-time payment that is made by a payor in connection with an associated alteration "is the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument." In the context of tax-advantaged bonds, this means that a one-time payment received by a holder in general will be treated as interest by the holder which, for tax-exempt bonds, will be treated as tax-exempt interest. The Proposed Regulations do not address over what period a one-time payment should be taken into account for tax-accounting purposes. This can be an important question in regard to tax-exempt interest, and NABL would like confirmation that each party may use any reasonable and consistently applied accounting method in taking into account the one-time payment. In most cases, for the issuer this will mean the payment is taken into account as a payment of interest on the date of the payment or receipt. Although the one-time payment may relate economically to the future period during which the debt instrument is outstanding, requiring that the one-time payment be taken into account over that period may be unnecessarily complex in many situations. Further, treating the one-time payment as a reduction in the original purchase price of the debt instrument or as a payment towards interest accrued to the date the one-time payment is made would cause all or part of such payment to be treated as taxable income with respect to a tax-exempt bond and potentially reduce applicable tax credit or federal subsidy amounts with respect to other tax-advantaged bonds, significantly frustrating the Treasury Department's interest in providing for the orderly transition from LIBOR for tax-advantaged bonds. Holders of tax-advantaged debt will have their own tax accounting considerations. For these reasons, NABL believes that it makes most sense to allow each party to use its own reasonable and consistently applied accounting methods.

b. One-Time Payment Received by Issuer is not Proceeds or Imputed Proceeds

The Proposed Regulations do not explain how the "source and character" rule should be applied under the rules that apply to tax-advantaged bonds in connection with a one-time payment received by an issuer. NABL believes that the natural interpretation of the rule is that such a payment is properly treated as reducing the interest paid, or to be paid, by the issuer. Under the tax-advantaged bond requirements, as is discussed below, "proceeds" only arise in connection with the sale of bonds. To the limited extent that the Regulations for tax-advantaged bonds address payments received by an issuer in connection with an alteration of bonds that does not result in a reissuance, such payments are not generally treated as "proceeds," but rather are treated as reducing the yield paid by the issuer for certain limited purposes.[10]

Accordingly, on the basis of the more detailed discussion below, NABL recommends that final Regulations clarify that one-time payments received by the issuer should not be treated as gross proceeds, proceeds, or imputed proceeds subject to the restrictions that apply to investment and use of tax-advantaged bond proceeds, or at most such payments should be treated as gross

[10] See, e.g., Treas. Reg. § 1.148-4(b)(4).

proceeds for arbitrage rebate purposes only. NABL acknowledges that amounts derived from a one-time payment could be treated as "replacement proceeds" because of a subsequent action taken by the issuer, but recommends that these amounts not be treated as replacement proceeds merely because they are derived from a one-time payment. For a further description regarding the relevance of whether amounts are treated as proceeds of tax-advantaged bonds and the reasons this should not be the case for a one-time payment received by an issuer, see Appendix A.

If, contrary to the recommendations and analysis set forth in this letter, the Treasury Department and the Internal Revenue Service determine that a one-time payment received by an issuer is required to be treated as any form of proceeds, NABL recommends that de minimis rules be applied so that such treatment would not be required in most cases. For example, NABL recommends that a de minimis rule should, at a minimum, apply such that a one-time payment not exceeding 5% of the outstanding principal amount of a debt instrument should not be treated as proceeds or imputed proceeds.

c. Provide Flexibility for Treatment under Arbitrage and Rebate Rules

NABL also requests that the final Regulations clarify how a one-time payment made or received by an issuer, should be treated for purposes of the Regulations relating to the arbitrage and rebate requirements of Section 148 of the Code. In general, those Regulations set forth different rules for variable yield issues and fixed yield issues. NABL believes that the vast majority of tax-advantaged debt with a LIBOR-referencing interest rate is treated as part of a variable rate issue under this framework. In certain special cases, however, such LIBOR-referencing debt could be treated as a fixed rate issue (if, for example, the debt is subject to a "qualified hedge" that causes the bonds to be treated as part of a fixed rate issue). Particularly in the case of variable rate issues, treating a one-time payment as a payment or receipt on the bonds would fit within the framework of the Regulations. NABL recommends flexibility, however, in how such a payment is reasonably allocated to different periods which correspond to yield calculation periods.

d. Provide Flexible Rules if Final Regulations Treat One-Time Payment as Proceeds

NABL is concerned that requiring a one-time payment received by an issuer to be treated as any form of proceeds under the tax-advantaged bond requirements in substance requires a retesting of those requirements in the same manner as a reissuance and would be complex and administratively burdensome. Accordingly, if the Treasury Department and the Internal Revenue Service require such treatment without the benefit of a de minimis approach of the type discussed above, NABL urges that the rules for use and investment of such proceeds be flexible. For example, final Regulations in this circumstance should expressly permit the use of the one-time payment to pay principal or interest on an issue in the same manner as permitted for unexpected excess sale or investment proceeds under Section 1.148-6(d)(3)(ii)(A)(6) (but without regard to Section 1.148-6(d)(3)(ii)(D) given these unique circumstances) and should not require such amount to be considered "net proceeds" or "proceeds" for purposes of the various expenditure requirements of, for example, Sections 142 through 145 of the Code. NABL is concerned that final Regulations that do not permit for such flexibility could interfere with a smooth transition from LIBOR-based transactions.

IV. Treatment of One-Time Payments and Integration with Respect to Qualified Hedges

Section 1.1001-6(c) sets forth a specific rule concerning the treatment of "qualified hedges" for the purpose of determining bond yield under the Regulations under Section 148 of the Code. Under that proposed rule, a modification to replace an interest rate referencing an IBOR with a qualified rate on a hedging transaction that is integrated as a qualified hedge under Section 1.148-4(h) is not treated as a termination of that qualified hedge under Section 1.148-4(h)(3)(iv)(B) if the modified hedge continues to meet the requirements of a qualified hedge under Section 1.148-4(h), as determined by applying the special rules for certain modifications of qualified hedges under Section 1.148-4(h)(3)(iv)(C).

Section 1.148-4(h)(3)(iv)(B) generally provides that a qualified hedge is deemed terminated for these arbitrage purposes if the issuer makes a modification that is material either in kind or extent. Section 1.148-4(h)(3)(iv)(C) generally provides that, even if a qualified hedge would so be deemed terminated, it will not be treated as terminated if the modified hedge meets the requirements for a qualified hedge on the date of the modification. This section also provides that, when determining whether the modified hedge is qualified, "the fact that an existing hedge is off-market as of the date of the modification is disregarded" and the hedge must be newly "identified" by testing required time periods for identification from the date of the modification.

Accordingly, the provision in Section 1.1001-6(c) appears to provide little additional relief, because the treatment of qualified hedges appears to be generally the same as if a qualified hedge were treated as terminated under existing Regulations. This provision, however, does not address certain additional questions that will arise under the qualified hedge provisions under Section 148 of the Code, including particularly the following: (1) the treatment of the permitted "one-time payment," and (2) the effect of permitted modifications on the treatment of tax-advantaged bonds as "super-integrated" (that is, treated as fixed yield bonds rather than variable yield bonds).

a. Treatment of One-Time Payment with Respect to Qualified Hedge

An "associated modification" includes "the obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate to offset the change in value of the . . . non-debt contract" such as an interest rate hedge. Consistent with the general approach of the Proposed Regulations, NABL requests clarification that such a one-time payment will be treated as not causing an alteration to fail to meet the requirements of Section 1.148-4(h)(3)(iv)(C) and that the one-time payment may be allocated in any reasonable method. NABL requests clarification on how such a payment should be accounted for when the payment is made or received on a "qualified hedge" under Section 1.148-4. NABL recommends that an issuer should be permitted to allocate such a one-time payment under any reasonable method for purposes of determining bond yield. NABL believes that, consistent with Section 1.148-4(h)(3), the Proposed Regulations should provide a safe harbor allowing the one-time payment to be reasonably allocated to the hedged bonds in the period to which the payment relates, generally based on the accounting requirements of Section 1.446-4. The accounting requirements of Section 1.446-4(e)(4) indicate that a "hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates."

b. Treatment of "Super-Integrated" Hedge

The Regulations under Section 148 set forth different rules for fixed yield issues and variable yield issues.[11] In general, the yield on a fixed yield issue is computed as of the issue date and is not affected by subsequent events, except to the limited extent provided in Section 1.148-4(b)(4) (relating to the treatment of the transfer of certain rights associated with a bond, as discussed above) and Section 1.148-4(h)(3) (relating to the termination of certain qualified hedges, as discussed below). The yield on a variable yield issue, on the other hand, is computed separately for each computation period, based on actual payments of principal and interest and qualified guarantees. Treatment as a fixed yield issue in many cases permits simplified tax compliance. Regulations concerning the treatment of qualified hedges of interest rate exposure for purposes of computing bond yield are set forth in Section 1.148-4(h). These Regulations generally permit payments and receipts on certain qualified hedges to be taken into account in determining bond yield. Subject to meeting certain requirements, a bond issue that would otherwise be treated as a variable rate issue but that is hedged to a fixed rate may be treated as a fixed yield issue for the purpose of determining bond yield under these rules. Such treatment is referred to as "super-integration."

Section 1.148-4(h)(4) states that a termination of a super-integrated qualified hedge may have the effect of causing the hedged bonds to be treated as reissued for rebate purposes under Section 1.148-3. The impact of this provision is to cause the fixed yield treatment of the bond issue to be terminated for arbitrage rebate purposes. A modification covered by Section 1.1001-6(a) would not be treated as a termination of the qualified hedge as long as the special rule contained in Section 1.148-4(h)(3)(iv)(C) applies. This special rule states that a modification of a hedge is not treated as a termination if the modified hedge is re-tested for qualification as a qualified hedge as of the date of modification and meets the requirements for a qualified hedge as of such date. In Section 1.148-4(h)(4)(iv) for super-integration purposes, however, the special rule is disregarded and a termination of the hedge is assumed except where the modification does not cause a change in yield of the issue of hedged bonds under Section 1.148-4(h)(4)(iii)(C). Consistent with the approach of the Proposed Regulations, NABL recommends that a modification covered by Section 1.1001-6(a) should not be required to cause such a super-integrated fixed yield issue to be treated as reissued for any purpose.

V. Limitation on Multiples in Determining Qualified Floating Rate

As anticipated in Section 1.1001-6(b)(1)(x), a "qualified rate" may take the form of a "qualified floating rate, as defined in Section 1.1275-5(b) (but without regard to the limitations on multiples set forth in Section 1.1275-5(b))," that is, without regard to the limitation on applying a multiplier that is greater than 65% but not more than 135% to an index, plus or minus a fixed rate. Section 1.1275-2(m)(2) states that in respect of a variable rate debt instrument "that provides both for a qualified floating rate that references an . . . IBOR and for a methodology to change the IBOR-referencing rate to a different rate in anticipation of the IBOR becoming unavailable or

[11] Treas. Reg. §§ 1.148-4(b) and 1.148-4(c).

unreliable . . . the IBOR –referencing rate and the different rate are treated as a single qualified floating rate for purposes of Section 1.1275-5."

By its terms, the proposed rule in Section 1.1275-2(m)(1) does not require the "different rate" adopted in anticipation of an IBOR becoming unavailable or unreliable to be a "qualified floating rate," whether that different rate is SOFR or another rate that satisfies Section 1.1001-6(b)(1)(x), *i.e.,* a qualified floating rate without regard to the limitations on multiples. That reading is further supported by the overall structure of Section 1.1001-6 whereby the adoption of a new qualified rate will not be treated as an exchange of a debt instrument for purposes of Section 1.1001-3. Otherwise, a variable rate debt instrument could become a contingent payment debt instrument without having undergone a reissuance.

If that is not a correct reading of Section 1.1275-2(m), NABL respectfully requests that the proposed section be modified to make clear that the "different rate" does not itself have to be a qualified floating rate under Section 1.1275-5(b) or that the definition of "qualified floating rate" under Section 1.1275-5(b) be amended to reflect the definition of "qualified rate" under the Proposed Regulations. In the alternative, the interest-based payment rules of Section 1.1275-4(d)(2)(ii)(D) could be amended to allow for the less onerous contingent payment debt instrument (CPDI) rules to apply in respect of a tax-advantaged obligation, irrespective of the multipliers applied in connection with implementing an otherwise qualifying alternative reference rate. As context for the comment and request in this paragraph, NABL provides a description of the contingent interest payment rules in Appendix B.

VI. Consistent Application of Proposed and Final Regulations

Section 1.1001-6(g) states that "taxpayers and their related parties . . . may apply this section to an alteration of the terms of a debt instrument or a modification of the terms of a non-debt contract that occurs before the date of publication of [final regulations], provided that the taxpayers and their related parties consistently apply the rules of this section before that date." Similarly, part 2(B) of the Explanation of Provisions section of the preamble to the Proposed Regulations states that Section 1.1001-6 may be relied on prior to publication of final Regulations "provided that the taxpayer and its related parties consistently apply the rules of [such section of the Proposed Regulations] before that date." It is not clear from the language concerning applicability whether a taxpayer and its related parties must be consistent in the application of Section 1.1001-6 in such circumstances with respect to all debt instruments and all non-debt contracts or whether the taxpayer or its related parties need only be consistent in such application with respect to a particular debt instrument or non-debt contract. NABL believes the latter interpretation is the correct reading of the applicability provisions but would welcome confirmation in final Regulations.

* * *

ATTACHMENT TO
NABL COMMENTS

WORKING GROUP MEMBERS

Matthias M. Edrich (Chair)
Kutak Rock LLP
1801 California Street, Suite 3000
Denver, Colorado 80202

Michael G. Bailey
Foley & Lardner LLP
321 North Clark Street, Suite 2800
Chicago, Illinois. 60654

Sarah A. Breitmeyer
Chapman and Cutler LLP
111 West Monroe Street
Chicago, Illinois 60603

Eorl H. Carlson
Jones Hall, A Professional Law Corporation
475 Sansome Street, Suite 1700
San Francisco, California 94111

Todd L. Cooper
Locke Lord LLP
7850 Five Mile Road
Cincinnati, Ohio 45230

Michela Daliana
Hawkins Delafield & Wood LLP
250 Greenwich Street, Floor 41
New York, New York 10007

Dennis L. Holsapple
Kutak Rock LLP
One South Wacker Drive, Suite 3910
Chicago, Illinois 60606

John W. Hutchinson
Squire Patton Boggs
6200 Chase Tower 600 Travis Street
Houston, Texas 77002

Perry Israel
Law Office of Perry Israel
610 Regency Circle
Sacramento, California 95864

Tyler J. Kalachnik
Ice Miller LLP
One American Square, Suite 2900
Indianapolis, Indiana 46282

Carol L. Lew
Stradling Yocca Carlson & Rauth, P.C.
660 Newport Center Drive, Suite 1600
Newport Beach, California 92660

Vanessa Albert Lowry
Greenberg Traurig, LLP
1717 Arch Street, Suite 400
Philadelphia, Pennsylvania 19103

John T. Lutz
McDermott Will & Emery
340 Madison Avenue
New York, New York 10173

William A. Milford
Bryant Miller Olive
1301 Riverplace Boulevard, Suite 2101
Jacksonville, Florida 32207

Susan Price
Ice Miller LLP
Arena District 250 West Street, Suite 700
Columbus, Ohio 43215

Kenneth B. Roberts
Hawkins Delafield & Wood LLP
250 Greenwich Street, Floor 41
New York, New York 10007

David A. Walton
Jones Hall, A Professional Law Corporation
475 Sansome Street, Suite 1700
San Francisco, California 94111

George Wolf
Orrick, Herrington & Sutcliffe LLP
405 Howard Street
San Francisco, California 94105

Alan Woolever
Gilmore Bell
2405 Grand Boulevard, Suite 1100
Kansas City, Missouri 64108

APPENDIX A
TO COMMENTS OF THE
NATIONAL ASSOCIATION OF BOND LAWYERS

DISCUSSION OF PROCEEDS RULES

The tax-advantaged bond requirements of the Code set forth several restrictions on the proceeds of tax-advantaged bonds. Depending on the type of bond, these restrictions include, but are not limited to, the arbitrage and rebate requirements that apply under Section 148 of the Code to all tax-advantaged bonds, the "private activity bond tests" that apply under Section 141 of the Code to governmental bonds and (in modified form) to qualified 501(c)(3) bonds, and special requirements for "qualified private activity bonds" generally set forth in Sections 142 through 147 of the Code. The arbitrage and rebate requirements generally apply to "gross proceeds" of tax-advantaged bonds. The private activity bond tests generally apply to "proceeds" of tax-advantaged bonds, and to property financed with such proceeds. The tests for qualified private activity bonds generally apply to "proceeds" of such tax-advantaged bonds and to property financed with those proceeds and, in certain limited cases, to "imputed proceeds."

Regulations under Section 148 of the Code define "gross proceeds" of an issue as "any proceeds and replacement proceeds of the issue."[12] "Proceeds" are generally defined as "any sale proceeds, investment proceeds, and transferred proceeds of an issue." "Sale proceeds" are generally defined as "any amounts actually or constructively *received from the sale* of an issue" (emphasis added). "Sale proceeds" also include, but are not limited to, "amounts *derived from the sale* of a right that is associated with a bond, and that is described in" Section 1.148-4(b) (emphasis added). Section 1.148-4(b)(4) contains a special rule that applies only for arbitrage rebate purposes (under Section 1.148-3). Under that rule, for the limited purposes of the rebate rules, as of the date of any "transfer, waiver, modification, or similar transaction (collectively, a *transfer*) of any right that is part of the terms of a bond or is otherwise associated with a bond (e.g., a redemption right), in a transaction that is separate and apart from the original sale of the bond, the issue is treated as if it were retired and a new issue issued on the date of the transfer." In computing the yield on the new issue, any amounts received by the issuer as consideration for the transfer are taken into account.

As set forth in this comment letter, IRS Notice 2008-41, as supplemented, provides for special favorable rules under which the interest rate conversion of a tax-advantaged qualified tender bond will not be treated as resulting in a reissuance. Under a special rule in IRS Notice 2008-41, qualified tender bonds converted to a fixed rate to maturity may be remarketed at a bond premium. Section 5.3 of IRS Notice 2008-41 provides that "[s]olely for purposes of the arbitrage investment restrictions under [Section 148 of the Code], any premium received by an issuer pursuant to a conversion of the interest rate for the remaining term of the bond to maturity in a qualified interest rate mode change . . . is treated as additional sale proceeds" as defined in Section 1.148-1(b). NABL recommends that, in the limited context of favorable rules in the Proposed Regulations to avoid market disruption, such treatment is not required by the

[12] Treas. Reg. § 1.148-1(b).

existing Regulations. If the approach of I.R.S. Notice 2008-41 is applied to an issuer's receipt of a permitted one-time payment under the Proposed Regulations, however, NABL recommends that a one-time payment should at most be treated as proceeds for arbitrage rebate purposes only.

Accordingly, under these existing Regulations, NABL believes that a one-time payment received under the terms of the Proposed Regulations should not be treated as "sale proceeds" of a tax-advantaged debt instrument because the Proposed Regulations provide that the transaction is not regarded as a "sale," and, therefore, such amounts are not received in connection with the sale of an issue. Nor are one-time payment amounts properly regarded as "transferred proceeds" or "investment proceeds" (because no funds have been "invested" by the issuer in respect of such payment). The special rule in Section 1.148-4(b)(4) should not apply, because the receipt of the one-time payment, under the terms of the Proposed Regulations, is not treated as a "modification" or a transaction similar to a modification.

Moreover, the special rule in Section 1.148-4(b)(4) is informative to this discussion in other respects. In effect, the special rule is an acknowledgement by the Treasury Department and the Internal Revenue Service that issuers should be required to account for deemed proceeds arising after the date of issuance only in very limited circumstances, in part because of the administrative burden and complexity of accounting for such deemed proceeds. Accordingly, the special rule requires amounts received in certain modifications to be taken into account, but only for purposes of the rebate rules that apply to investments. The special rule does not apply for purposes of other restrictions on use of proceeds, in large part because to do so would subject issuers to unreasonable administrative burdens and complexity.

"Replacement proceeds" are defined under detailed provisions in the Regulations and generally consist of amounts that are not directly derived from proceeds but that have a significantly direct nexus to the tax-advantaged debt instrument to be treated as properly subject to the arbitrage and rebate rules that apply to investments. In general, 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 for that governmental purpose."[13] Under this framework, a one-time payment received by an issuer under the terms of the Proposed Regulations should not be treated as "replacement proceeds" merely because the amount is received in connection with the alteration of the debt. NABL acknowledges, however, that subsequent actions taken by the issuer (such as setting aside the one-time payment in a fund to pay debt service on the issue) could cause such amounts to be treated as gross proceeds, but only in the same manner as any other funds held by the issuer.

The definition of proceeds for purposes of the "private activity bond tests" of Section 141 of the Code is based on the same definition of "sale proceeds" that applies for purposes of Section 148 of the Code. Proceeds for this purpose include any investment proceeds from investments that accrue during the project period.[14] In addition, the Internal Revenue Service may treat any

[13] Treas. Reg. § 1.148-1(c).
[14] Treas. Reg. § 1.141-1(b).

"replaced amounts" as proceeds. This same definition applies to qualified private activity bonds under Section 145 of the Code.[15]

NABL believes that the one-time payment should not be treated as "proceeds" of an issue for purposes of Sections 141 or 145 of the Code for the same reasons as set forth above regarding the treatment of proceeds for purposes of Section 148 of the Code. In addition, such amounts are not properly regarded as "replaced amounts."

The definition of "proceeds" for purposes of other types of qualified private activity bonds is generally understood to be the same as the definition that applies for purposes of Sections 141 and 145 of the Code. In addition, Regulations under predecessor provisions to the current rules in the Code concerning certain types of qualified private activity bonds provide that "imputed proceeds" from certain "deep discount bonds" are required to be treated as proceeds for purposes of use-of-proceeds requirements.[16] In general, the imputed proceeds rules are intended to inhibit the use of discount bonds to finance working capital (*i.e.,* current interest expense) for bonds with specified capital expenditure requirements. In general, these Regulations treat certain amounts that are similar to accruing original issue discount as "imputed proceeds" that may arise after the date of issuance. The imputed proceeds of an issue generally equal the sum of the imputed proceeds for each annual period over the term of a bond issue. The amount of imputed proceeds for a bond year equals the sum of amounts of interest and principal that accrue with respect to the issue in such bond year, reduced (but not below zero) by the sum of amounts of principal and interest that become payable with respect to the issue in that bond year. The Regulations provide, however, that there are no imputed proceeds with respect to an obligation if (1) the obligation does not have a stated interest rate (determinable on the date of issue) that increases over the term of the obligation and (2) the purchase price of the obligation is at least 95 percent of the face amount. For this purpose, if the actual rate at which interest is to accrue over the term of the obligation is indeterminable at the date of issue then, in computing the yield on the obligation, such rate is to be determined as if the conditions as of the date of issue will not change over the term of the obligation.

The rules for "imputed proceeds" in Sections 1.103-8(a)(6) and (7) are framed in terms of a determination made "as of the date of issue." Under the Proposed Regulations, a one-time payment may be treated as not constituting a modification, and as not resulting in any deemed sale or purchase. Accordingly, under the terms of the Proposed Regulations, a one-time payment should not result in any "imputed proceeds."

The foregoing interpretation and analysis of the Proposed Regulations is consistent with the treatment of tax-advantaged bonds under the Code and existing published guidance. In general, the tax-advantaged bond restrictions of the Code do not purport to always precisely reflect economic substance, and often depart from pure economic substance to achieve requirements that are readily administrable. Accordingly, at least in the case of governmental bonds and qualified 501(c)(3) bonds, the restrictions on use of proceeds and financed property are based on proceeds received at initial issuance and do not apply to any imputed proceeds. For example, the rules for governmental bonds and qualified 501(c)(3) bonds clearly permit the issuance of "deep discount"

[15] Treas. Reg. § 1.145-2.
[16] Treas. Reg. § 1.103-8(a)(6) and (7).

(and even zero coupon) tax-advantaged bonds and do not require the original issue discount accruing and not currently paid in such cases to be treated as imputed "proceeds" that are borrowed in each year but not paid until a later date.

NABL acknowledges that the policy considerations that apply to most other types of qualified private activity bonds are somewhat more complex, because, to a limited extent, the requirements for those qualified private activity bonds do need to take into account certain imputed proceeds that arise after the initial issuance. In general, the Code subjects qualified private activity bonds to a number of stricter requirements that do not apply to governmental bonds. Even in the case of such qualified private activity bonds, however, NABL recommends that final Regulations should clarify that a one-time payment received by an issuer is not properly treated as "proceeds" or "imputed proceeds" in order to avoid undue administrative burden and complexity.

* * *

APPENDIX B
TO COMMENTS OF THE
NATIONAL ASSOCIATION OF BOND LAWYERS

DISCUSSION OF CONTINGENT INTERST PAYMENT RULES

If an interest payment is not fixed as to both time and amount, it may be a contingent interest payment and subject to the contingent interest payment rules, unless, among other requirements, the instrument qualifies as a variable rate debt instrument or "VRDI."[17] To qualify as a VRDI, a tax-exempt bond must bear interest using a formula that is based on one or more "qualified floating rates," a "qualified inverse floating rate," or a "qualified inflation rate." In addition, interest on the bond must be compounded or paid at least annually based on current values of a permitted interest rate formula.

Section 1.1275-4 applies a "noncontingent bond method" in respect of both taxable and tax-exempt CPDIs. Under the noncontingent bond method, interest accrues on a CPDI at a rate equal to the instrument's "comparable yield," which is the yield at which an issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the CPDI. In addition, the noncontingent bond method treats all interest on a debt instrument as original issue discount that must be taken into account as it accrues, regardless of the taxpayer's normal method of accounting.

Under the noncontingent bond method, the comparable yield is used to construct a projected payment schedule for the debt instrument, which includes a projected amount for each contingent payment. If the actual amount of a contingent payment is greater than the projected amount, the difference is treated as additional interest for the taxable year. If the actual amount of a contingent payment is less than the projected amount, the difference first offsets the interest that otherwise accrued on the debt instrument for the tax year based on the projected payment accrued on the debt instrument for the year under the projected payment schedule. The excess is treated as an ordinary loss by the holder (or as ordinary income by the issuer) to the extent of prior interest inclusions (or deductions), plus prior net positive adjustments and minus any prior negative adjustment. Any excess amount is carried forward to succeeding years and, if not used by the time the instrument is sold or matures, is treated as a reduction in the amount realized on the sale or retirement of the CPDI.

Issues of tax-exempt obligations that are considered to have contingent payments are governed by special provisions under the VRDI rules and the CPDI rules. Section 1.1275-4(d) provides rules for covered tax-exempt CPDI. For purposes of applying the noncontingent debt method to tax-exempt debt, the Regulations effectively cap the tax-exempt yield by capping the yield used to measure projected payments. This cap is equal to the greater of (a) the yield on the tax-exempt debt determined by excluding the contingent payments or (b) the tax-exempt applicable federal rate (the "TE AFR"). The TE AFR is a composite measure of tax-exempt AA

[17] See, Treas. Reg. § 1.1275-4(a)(2)(ii).

prime general obligation market rates that is published monthly by the Internal Revenue Service. The projected yield and payments are based on this capped tax-exempt yield.

Under these rules, if actual payments are greater than projected payments on covered tax-exempt CPDIs in any taxable year, all those excess payments generally are treated as taxable gains to the holder from the sale or exchange of the tax-exempt CPDI in the taxable year of the adjustment, as distinguished from the treatment of such excess payments in respect of a taxable CPDI as additional interest. The portion of the interest on an otherwise tax-exempt bond that is considered to be "contingent" is therefore taxed to the extent the actual payments exceed projections, with projections capped at the TE AFR. Shortfalls between projected and actual payments are treated as taxable losses to the holder from the sale or exchange of debt in the taxable year of the shortfall, rather than as nondeductible adjustments to tax-exempt interest.

The Regulations provide an alternative to the complex and onerous rules described above in respect of "interest-based payments" on tax-exempt CPDIs. Such bonds include bonds with certain interest rate formulas that otherwise fail to meet the definition of VRDI for modest technical reasons, including that the applicable multiple is between zero and 65%. If a tax-exempt CPDI qualifies under these provisions, the noncontingent bond method is applied in a manner similar to how it applies to taxable CPDI. The TE AFR cap described in the general rules set forth above does not apply in respect of interest-based tax-exempt CPDIs, with the result that the actual payments above the projected payments may be considered tax-exempt interest in their entirety. If the actual payments are less than the projected payments, the shortfalls are treated as reductions in the holder's tax-exempt interest income on the debt. If the actual payments result in net shortfalls compared with the projected payments, the loss is suspended, and the holder can recognize tax losses to the extent it has not recovered its investment.[18]

The preamble to the final CPDI rules published in the Federal Register[19] explains in respect of the general rules governing the treatment of tax-exempt CPDIs, that "[t]hese modifications to the noncontingent bond method for tax-exempt obligations were added because the IRS and Treasury believe that when a property right is embedded in a tax-exempt obligation it is generally inappropriate to treat payments on the right as interest on an obligation of a state or political subdivision." The preamble continues, saying: "[t]he IRS and Treasury . . . recognize that certain types of traditional tax-exempt financings should not be subject to the interest limitations of the proposed regulations (e.g., financings on which interest is computed in a manner that relates to the cost of funds). Accordingly, §1.1275–4(d) has been revised to include a category of tax-exempt obligations that will be subject to the noncontingent bond method without the tax-exempt interest limitations contained in the proposed regulations. This category of tax-exempt obligations includes (1) obligations that would qualify as variable rate debt instruments (VRDIs) except for the failure to meet certain of the technical requirements of the VRDI definition (such as the cap and floor limitations, or the requirement that interest be paid or compounded at least annually)."

The recharacterization of an otherwise "qualified rate" in respect of an instrument that is clearly a debt instrument as a contingent payment on the grounds that it does not fall within the

---

[18] See, Treas. Reg. § 1.1275-4(d)(2)(iv).
[19] 61 Fed. Reg. 30127, 30135 (Jun. 14, 1996).

current definition of qualified floating rate under Section 1.1275-5(b) appears unwarranted. Moreover, subjecting any such tax-exempt debt instrument to the strict rules of Section 1.1275-4(d)(3) because the appropriate multiplier exceeds the 135% limit of the current Regulations, causing the holder of such a debt instrument to limit its receipt of tax-exempt income to an amount equal to the TE AFR would seem to contradict the spirit and intent of the Proposed Regulations. NABL respectfully requests that the Treasury Department consider the ramifications of imposing the complex rules applicable to CPDIs to debt instruments, including tax-exempt debt instruments, solely as a consequence of attempting to implement changes to the applicable reference rates for such instruments as is otherwise contemplated and facilitated by the Proposed Regulations.

*   *   *