REPORT #636

TAX SECTION

New York State Bar Association

REPORT ON THE TEMPORARY AND PROPOSED REGULATIONS RELATING TO ARBITRAGE RESTRICTIONS ON TAX-EXEMPT BONDS PUBLISHED IN THE FEDERAL REGISTER ON

MAY 15, 1989

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November 30, 1989

The Honorable Fred T. Goldberg
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed please find a Report by our Tax Exempt Bond Committee on the Temporary and Proposed Regulations relating to arbitrage restrictions on tax-exempt bonds published in the Federal Register on May 15, 1989, as amended by Advance Notice 89-78, released June 30, 1989 (the “Rebate Regulations”). The Report was prepared by the Co-Chairs of the Committee and the Rebate Subcommittee.

The Report expresses the view that while the Rebate Regulations contain a number of provisions that are commendable, substantial revisions in the Rebate Regulations are needed to address the following major concerns:

1. The rebate rules applicable to the vast majority of issuers of tax-exempt obligations are too complex to be understood by these issuers or by most of the professionals that assist them on a regular basis; simplification is badly needed, especially for small issues (for which the Committee believes a level in the range of $30 million would be an appropriate dividing line).

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2. The approach in the regulations focuses inappropriately on seeking to reach and tax every dollar of potential arbitrage benefit rather than focusing on implementing the Congressional objective of deterring premature or excessive bond issuance or the extension of bond maturities for the substantial purpose of earning arbitrage rebates. That focus is a source of considerable unproductive (and unnecessary) complexity in the regulations. It also appears to be the source of certain positions that are inappropriately penal in operation, particularly with respect to advance refunding more than ninety days prior to the first call date of the existing obligations being refunded.

The Report also makes a number of comments of a more specific nature for suggested revisions or requests for clarifications in the Rebate Regulations.

Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure

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Tax Report #636

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Tax-Exempt Bonds
November 30, 1989

REPORT ON THE TEMPORARY AND PROPOSED REGULATIONS RELATING TO ARBITRAGE RESTRICTIONS ON TAX-EXEMPT BONDS PUBLISHED IN THE FEDERAL REGISTER ON

MAY 15, 1989

AS AMENDED BY ADVANCE NOTICE 89-78, RELEASED

JUNE 30, 1989

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Tax-Exempt Bonds*

REPORT ON TAX-EXEMPT BONDS REBATE REGULATIONS

BACKGROUND AND OVERVIEW

This report addresses the Temporary and Proposed Regulations (T.D. 8252) published in the Federal Register on May 15, 1989, as amended by Advance Notice 89-78, 1989-30 I.R.B. 6, released June 30, 1989. The Temporary and Proposed Regulations, 1.148-OT through 1.148-9T, 1.149(d)-1T, 1.150-OT and 1.150-1T (the “Rebate Regulations” or “Proposed Regulations”), along with a 68 page preamble (hereinafter, the “Preamble”), were originally contained in 243 typewritten pages.**

1. The “Rebate” Concept.

The Rebate Regulations address a topic of fundamental concern to all State and local government issuers -- the ability of these issuers to use the “arbitrage” profit derived from the difference between the low tax-exempt yield on their obligations and the higher taxable yield on the issuer's investments purchased with proceeds of these obligations for a governmental purpose. Throughout this decade there has been an increasing

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* This report has been prepared by the Tax-Exempt Bond Committee (the "Committee") Co-chairs, Stephen P. Waterman and Henry S. Klaiman and Committee members: Dale S. Collinson, Alexander T. Deland, Christopher Fink, Eugene Lowenstein, Valerie A. Molinaro, Richard H. Nicholls, Mitchell Rapaport, Joseph P. Rogers, Jr., Edward J. Rojas, Scott E. Schickli, Robert K. Sharp, Robert M. Shepard, Mark L. Shifke and Jeremy A. Spector. William L. Burke, the Chair of the Tax Section, provided valuable comments and suggestions with respect to this report.

** References to page numbers within the Rebate Regulations throughout this report refer to the original release to the public by the Federal Register on Friday, May 12, 1989.

concern within the Treasury Department and Congress that certain State and local government obligations have been issued for the primary purpose of creating arbitrage profit as opposed to the acquisition and construction of public purpose projects and operations.

The “rebate” concept itself has developed as a means for the federal government to remove arbitrage profit as an incentive for issuance of tax-exempt obligations. For State and local government tax-exempt obligations subject to this “rebate” requirement, issuer's must pay to (or “rebate” to) the federal government an amount that approximates the arbitrage profit. Given that this arbitrage profit is viewed by the Treasury Department as a form of federal subsidy solely attributable to the spread between low yielding tax-exempt obligations and higher yielding taxable investments, the rationale behind the “rebate” requirement is that the arbitrage profit should be returned to the federal government.

The “rebate” concept first became part of the Internal Revenue Code of 1954 with the enactment of the Mortgage Subsidy Bond Tax Act of 1980. This Act limited the application of the rebate requirement to single family and qualified veterans mortgage revenue bonds and provided issuers with an option to rebate the arbitrage profit to the federal government or the mortgagors. The Deficit Reduction Act of 1984 extended the rebate requirement to most types of industrial development bonds. For these obligations, rebate was required to be paid only to the federal government. Rebate Regulations were promulgated under this Act on January 7, 1985, set forth in Temp. Treas. Regs. Section 1.103-15AT.

Congress extended the rebate requirement to all types of tax-exempt obligations as part of the Tax Reform Act of 1986 (the "1986 Act"), including obligations for purely governmental projects and operations. This new, expanded version of the rebate requirement (the "Rebate Requirement") is set forth in Section 148(f) of the Internal Revenue Code of 1986, as amended (the "Code"). All rebate payments must be paid to the federal government under Section 148(f), including rebate payments with respect to single family and qualified veterans mortgage bonds. The scope of the new Rebate Regulations is not limited to Section 148(f) of the Code. Rather, these regulations are promulgated pursuant to, and change many of the substantive arbitrage rules prescribed by, Sections 148 and 149(d) of the Code.

2. A Problem of Complexity and Need for Simplification.

The Committee recognizes the immense effort that the Treasury Department has expended in preparing the Rebate Regulations, the first of an expected two or three sets of regulations needed to complete the Congressional mandate to issue regulations on this subject. The Committee also acknowledges that this first set of regulations establishes certain principles and confirms others for which the Treasury should be applauded.

The Committee believes, however, that the complexity of the Proposed Regulations and the number of practical day-to-day compliance issues that are not effectively addressed are major problems. We believe that the multitude of complex initial individual calculations, joint computations, subsequent event computations, etc. will discourage accurate compliance by all but the very few who can afford to dedicate substantial time and funds to the implementation of these regulations. The complexity is such that even the most sophisticated and astute public official will not be capable of implementing them either because of their complexity or because of the inability of overworked public officials who do infrequent bond transactions to devote adequate time to their understanding. Furthermore, those professionals such as attorneys and accountants who will study and learn these rules will be relatively few and we anticipate they will disagree, as they already have, as to the proper interpretation of many provisions.

The Committee believes that one major reason for the complexity is that the Rebate Regulations are not designed just to eliminate significant arbitrage but rather are intended to capture any amount, no matter how minor and irrelevant to the basic commercial decisions involved. The necessity of imposing such a complex mechanism as the Proposed Regulations, even assuming the theoretical economic accuracy of the underlying assumptions, for the purpose of capturing this small incremental positive arbitrage is not, in the Committee's view, an appropriate approach and should be reexamined. The Committee believes that this area is a prime example of a place to heed the comment of Commissioner Goldberg, reported in the September

5, 1989 Daily Tax Report, in which he called for an infusion of common sense into the process of formulating regulations and a willingness to abandon “theoretical purity.” Even though the rebate responsibility is statutorily mandated, the Treasury has the authority to adopt simplified accounting standards for administrative convenience. The Committee believes that the Treasury can and should exercise this authority more affirmatively than is presently reflected in the Proposed Regulations.

Although there are various recommendations contained in this report that suggest more detailed rules be provided in the final regulations, the Committee wishes to stress that (1) these detailed rules are generally required only as an alternative to deleting what is otherwise provided in the Rebate Regulations concerning the applicable subject, and (2) these more complex rules are not intended to apply, and should not have to apply, to the vast majority of issuers.

We recommend that the Rebate Regulations be substantially redrafted to simplify them. One step that will contribute to that objective is to limit their scope with the understanding that perhaps not every positive arbitrage dollar, in a theoretical sense, will be rebated, accepting the imperfection as part of the price of a practical and administrable set of provisions. A second, more technically explicit step would be to withdraw the proposed rules relating to the important concept of “transferred proceeds” and substitute a prescribed formula which should improve uniformity, thus eliminating abuses and errors in the interpretation and application of the Rebate Regulations.

Independent of any pending legislation discussed herein, the Committee also recommends that Treasury simplify the administrative burden of compliance by exercising its authority to adopt the following special rules for fixed yield non-refunding issues:

(i) Either eliminate the requirement to recalculate yield on an issue in the event of an early retirement or redemption or, at the very least, expand the scope of the definition of an "eligible small issue" under Rebate Regulations Section 1.148-3T(c)(4)(ii) to include any tax-exempt obligation the aggregate principal amount of which is $30,000,000 or less;

(ii) Permit the use of the approximate method for computing the present value of any fixed rate non-purpose investments defined as "eligible investments" in Rebate Regulations Section 1.148-2T(e)(5)(ii) even where such investments are sold with de minimis amounts of discount or premium; and

(iii) Provide a de minimis rule for discount or premium for purposes of applying the yield-to-call rules and the special rule for obligations sold at a discount that are subject to mandatory early redemption pursuant to Rebate Regulations Section 1.148-3T(b)(4) and (b)(7)(iii), respectively.

The Committee also submits the following further suggestions for simplification:

(a) Calculate rebate to the final retirement date of an issue and waive the rebate with respect to timely paid final payments -- not just the amount expressed in the "de minimis" mile of Rebate Regulations Section 1.148-1T(b)(2)(iv).

(b) Allow reasonable transaction costs with regard to investments. (See page 98 of the Rebate Regulations.)

(c) Allow a fee for a qualified guarantee to be included in yield calculations on an "issue" basis rather than a bond-by-bond basis. It is unreasonable to assume that an issuer would guarantee certain bonds when the present value of the interest saved does not exceed the fee attributable to the bond unless there exists an overall saving on the issue (inclusive of distribution costs that would relate to any uninsured portion of an issue). (See pages 135 and 136 of the Rebate Regulations.)

(d) Amend Rebate Regulations Section 1.148-2T(d) (see page 110 of the Rebate Regulations) describing the methods by which fair market value is to be determined by modifying the first sentence to substitute “purchases” for “would purchase” in order to confirm that an arm's length transaction is sufficient to determine fair market value.

(e) Amend all transition rules that except out “refunding issues to which Section 149(d)(4)” applies and, if necessary, replace it with “advance refunding issues.”

(f) Provide that all fees of an issuer which the arbitrage regulations permit an issuer to collect are deemed expended for rebate purposes. (See page 215 of the Rebate Regulations.)

(g) Eliminate the requirement that the rebate liability of a refunded issue be paid in order for a refunding issue to maintain its tax-exempt status.

Prior to revising the Rebate Regulations, the Committee recommends that certain proposed rules discussed in the Preamble (see Part 1(1)) be immediately clarified by means of an advance notice to provide guidance to issuers.

3. Uniformity for Yield Restriction and Rebate Purposes.

The Committee recommends consistent rules for arbitrage yield restriction and arbitrage rebate purposes, in general, under Rebate Regulations Section 1.148-9T. For arbitrage yield limitation purposes, issuers have historically been able to rely upon a simple actuarial yield calculation for fixed yield obligations. Treas. Regs. Section 1.103-13(c)(1). Issuers have had no guidance as to the calculation of yield for variable yield obligations because Treas.

Regs. Section 1.103-13(c)(1) did not recognize their existence. The prior rebate regulations retained the actuarial yield method of -13(c)(1) for fixed yield obligations and progressed one step further by providing a mechanical formula for variable yield obligations. Temp. Treas. Regs. Section 1.103-15AT(b)(3) and (c)(4)(i).

The Rebate Regulations have digressed by eliminating the simple, straightforward actuarial yield method of -13(c)(1) for fixed yield obligations -- not just for rebate purposes, but for arbitrage yield limitation purposes as well. And although the Rebate Regulations provide a mechanical formula for calculation of yield on variable yield obligations for rebate purposes, issuers are still without any guidance as to the proper methodology for computation of yield on such obligations for arbitrage yield limitation purposes.

The Committee recommends that the final regulations apply the methodology for computation of yield on variable yield obligations for all purposes under Section 148 of the Code, not just for rebate purposes. The Committee recommendations concerning the computation of yield for both fixed and variable yield obligations are discussed in Part III, below.

4. Drafting Style.

The Rebate Regulations are made more difficult to understand by the failure to identify the specific abuses the regulations are attempting to curtail. In addition, the Rebate Regulations (a) do not consolidate definitions in one place, (b) fail to provide sufficient general principles before addressing actual abuses, and (c) fail to sufficiently identify the point being addressed before establishing rules which must be understood and complied with. The use of additional examples might reduce complexity as much of the language, by itself, is not comprehensible to those unfamiliar with the problems being addressed. There are also bound to be interpretative problems, regardless of the care and attention Treasury gives to redrafting these regulations. Therefore, we suggest a general statement be included in the final Rebate Regulations to the effect that interpretive questions be resolved so that the arbitrage and rebate analysis does not result in a loss, other than for transaction and administrative costs.

5. Timely Announcements.

The Committee believes that this is an area in particular where the Treasury and the public would be better served if perceived abuses are timely addressed (“chilled”) in the form of announcements which are rapidly drafted and released to the public prior to being placed in regulations. There are several types of abusive transactions specifically addressed in the Rebate Regulations that could have been stopped when they were being structured by means of a timely announcement. Prohibiting these types of transactions in proposed regulations months after, and in some cases years after, their original proponents have stopped structuring and closing such transactions is not a meaningful exercise.

6. Cooperative Effort.

The Committee also believes that the Treasury would be well served if, in this area, it would invite comments on particular matters or approaches it may be considering before it promulgates formal regulations or announcements. We believe that the need to meld effective administration and market practices is particularly accute in this area, and that the public comment that will be elicited will be of substantial assistance in formulating practical and effective rules.

The Committee stands ready to cooperate with Treasury in developing less complex, more workable regulations. The Committee is prepared to assist in drafting regulations in those areas in which the Treasury expresses an interest in accepting our comments and recommendations.

Part I. PREAMBLE

This Section of the report discusses issues raised by the Preamble to the Rebate Regulations, generally excluding matters specifically addressed by the Rebate Regulations.

1. Status as Authority.

Prior to the issuance of Advance Notice 89-78, press reports of statements by Treasury or IRS officials indicated that a notice would be issued authorizing issuers to rely on certain favorable rules previewed in the Preamble as being the subject of future regulations. The Committee strongly supports such an approach because of the uncertain precedential value of the Preamble and urges prompt issuance of such a notice. The notice should state rules in a form upon which issuers can rely.

A general reference to reliance on rules contained in the Preamble is not appropriate, however, because these rules in many cases are not sufficiently detailed for purposes of uniform application by financial professionals. Instead, the Committee recommends that rules for which further guidance has been sought herein below be included in the notice without delay to enable issuers and public finance professionals to apply the rebate rules in a consistent and reasonable manner. Independent of pending legislation, among the rules that should be included in the forthcoming notice are explanations and guidelines regarding the extent to which:

(1) existence of a reserve fund will not disqualify an issue for the six-month safe harbor exception to the Rebate Requirement;

(2) proceeds can be commingled with other funds and rebate calculated in accordance with specified customary accounting practices; and

(3) expenses of certain commingled funds can be taken into account in calculating yield on investments (which will have the effect, to the extent allowed, of simplifying the calculations and permitting proper expenses to be recouped by the issuer).

Certain of the above-recommended rules are discussed in more detail below.

2. Exception to Rebate Requirement for Non-Tax Motivated Transactions.

The Preamble (at page 12) invites comments regarding special rules that may be necessary to encourage greater reliance on the six-month expenditure exception. As discussed in more detail below, pending legislation in Congress would expand the six-month expenditure period to two years in certain cases. This pending legislation represents a Congressional recognition that the statutory exceptions to the Rebate Requirement are too narrow. The Rebate Regulations compound this problem by requiring most issuers that do not meet the statutorily prescribed exceptions to compute the Rebate Requirement in accordance with very complicated rules.

The Committee believes that the complexity and administrative burdens of the precise rebate calculations in the Rebate Regulations should not apply to the vast majority of public finance transactions if (i) proceeds are actually spent for a governmental purpose within the construction period necessary for completion of the project and (ii) any arbitrage profits are promptly used for the purposes of the project or to redeem bonds. Such simplification will concentrate the efforts of State and local issuers on the project rather than on the establishment and implementation of complex administrative procedures necessary to comply with the Rebate Regulations. This simplification should result in bonds being issued in smaller amounts due to the investment of arbitrage earnings in the project.

The Committee endorses the general approach of the expenditure provision set forth in the Omnibus Budget Reconciliation Act of 1989 (H.R. 3299) recently approved by the Joint Conference Committee composed of certain numbers of the Senate Finance Committee and the Ways and Means Committee of the House of Representatives. Section 7652 of H.R. 3299 permits an issuer to elect to meet certain expenditure requirements (the “Expenditure Exception”) with respect to a bond issue in lieu of compliance with the Rebate Requirement. The Expenditure Exception provides an alternative to the six-month exception to the Rebate Requirement and is limited to tax-exempt bond issues at least seventy-five (75) percent of the proceeds of which (exclusive of a reserve fund) are to be used for construction (including rehabilitation and reconstruction) projects owned by governmental units and organizations described in Section 501(c)(3) of the Code.

Under the Expenditure Exception, bond proceeds (other than reserve fund deposits) and interest earnings on bond proceeds (including reserve fund earnings) must be expended for the governmental purpose of the issue from the date of issue, as follows: (i) 10% by the end of the first six months; (ii) 45% by the end of twelve months; (iii) 75% by the end of eighteen months; and (iv) all 100% by the end of twenty-four months (except for certain “retainage”). Section 7652 permits up to five percent of such proceeds to be spent during the third year from the date of issue provided that this amount consists of “retainage” that is contractually required to be withheld.

are available to the issuer, including a statutorily prescribed penalty in lieu of compliance with the Rebate Requirement upon failure to satisfy the foregoing expenditure requirements.

If this is pending or any similar legislation is not enacted into law, the Committee recommends adoption of a rule similar to the Expenditure Exception in the final Rebate Regulations.

3. Qualification for the Six-Month Safe Harbor to Rebate.

In response to the request (at page 12 of the Preamble) that special rules be identified to encourage greater reliance on the six-month exception to rebate, the Committee endorses the view of H.R. 3299 that the six-month safe harbor be available when an issue has a reasonably required reserve fund funded from bond proceeds or other sources. If the pending or any similar legislation is not enacted into law, the Committee recommends adoption of this rule in the final Rebate Regulations.

In the context of a current refunding (*i.e.*, a refunding bond issue the proceeds of which are used to retire the prior issue within 90 days of the date of issue of the refunding issue), the Committee recommends that the final regulations permit each refunding issue to be analyzed under the six-month exception independently of the original or prior issue. Thus, in circumstances where there are unspent proceeds of the prior issue on the date of issue of the refunding issue, the refunding issue would be eligible for the six-month exception without regard to any transferred proceeds, except that investments made with transferred proceeds would be subject to the Rebate Requirement. For purposes of applying the Rebate Requirement to such transferred proceeds, the amount of the rebatable arbitrage would be measured by the yield on the refunding issue (to match the current cost of funds) beginning on the date that the prior issue is redeemed.

The Committee endorses the special safe harbor discussed in the Preamble which applies if substantially all, but not all, of the gross proceeds of the issue are spent within six months, and the delay in spending the gross proceeds is due to unanticipated events over which the issuer has no control. Examples of such unanticipated events include “Acts of God” that adversely affect the timely completion of the construction of the project, or other factors influencing construction such as judicial proceedings, labor strikes, delays in the permitting process or delays in receipt of project materials and equipment. In providing a special safe harbor, the Preamble reference to “substantially all” of the proceeds should not be interpreted as ninety percent. See Treasury Regulations Section 1.103-8(a)(1). The Committee recommends that the safe harbor rule be applicable regardless of the amount of bond proceeds actually spent so long as the issuer expects to expend the proceeds in a timely manner as of the date of issue and its investment of bond proceeds is consistent with that expectation. Treasury Regulations Section 1.103-14(b)(2),(3) and (4). For purposes of this exception, so-called “hedge bonds” (where proceeds are invested in long-term guaranteed investment contracts) would be excluded. See Section 7651 of H.R. 3299.

In the case of equipment financings, the Committee recommends the adoption of a safe harbor rule in those jurisdictions where, under the applicable State or local law, the issuer is required to first issue the obligations prior to solicitation of bids from equipment vendors. This bidding process, together with the time required to procure the equipment (particularly where the machinery or equipment is required to be manufactured to the issuer's specifications), commonly results in a delay in the expenditure of bond or note proceeds beyond the six-month deadline. Accordingly, the Committee requests that the final regulations include a safe harbor rule that defines an “event beyond the control of the issuer” to include State law restrictions on the timing of the issuance of an equipment financing where public bidding is statutorily required after the date of issue.

In the case of obligations issued as part of a “series,” only one six-month period is allowed under current law. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess., at 1208. The explanation of this “series” rule in the Senate Finance Committee Report seems to limit its application to refundings and single issues of bonds where more than one draw-down of proceeds occurs. S. Report 99-313, 99th Cong., 2nd Sess., at 847. The six-month period begins on the date on which the first obligations in the series are issued. This “series” rule would seem to clearly apply to periodic purchases of bonds pursuant to a binding agreement.

The Committee believes that the scope of the “series” rule in the final regulations should be limited to “draw-down” or “grid” notes, where interest becomes payable on the notes as proceeds are drawn at predetermined rates of interest. By contrast, this “series” rule should not include the funding of a project to be completed in stages using a succession of new money bond anticipation notes, because allowing issuers a separate six-month exception for each issue with respect to a project completed in stages (i) encourages issuers to postpone the issuance of obligations until the issuer is in a position to expend all the proceeds within six months and (ii) encourages expedient expenditure by issuers who are likely to invest construction fund proceeds for shorter periods of time.

4. Simplified Accounting Rules for Funds.

The Preamble provides that States may form “funds” similar to widely held mutual funds with the result that only “dividends” paid by the fund to investors will be taken into account for purposes of computing rebate. In other words, an issuer who invests in such fund need not look through the fund to analyze its underlying investments and expenses in order to compute rebate. The Preamble does not provide guidance as to the criteria which must be met to receive this special treatment. Clarification is requested concerning the meaning of the term “widely held mutual fund,” particularly what satisfies “widely held” for this purpose in order for this provision to have practical significance. Also, the clarification should address situations in which immediate reinvestment does not occur and provide permissible periods of time without imputed earnings.

The relief for a “widely held” form of mutual fund should not be limited only to funds established by States. Perhaps the application of this special rebate computation rule was limited to State - sponsored funds because of a concern that funds established by local issuers may permit the diversion of profits from funds by means of fees that are other than arms length. The Committee believes that the same market forces insure fair market value as to fees and rates of return regardless of whether the fund is established at the State or local level. Accordingly, any State or local fund satisfying the “widely held” criteria should be entitled to compute rebate with regard to dividends paid to investors.

5. Definition of “Gross Proceeds”.

Under the Rebate Regulations, the term “gross proceeds” means with respect to a bond issue, any proceeds of the issue and any funds (other than bond proceeds) that are part of a reserve or replacement fund for the issue. Rebate Regulations Section 1.148-8T(d). For this purpose, the term “proceeds” of the issue includes (1) “original proceeds,” i.e., the proceeds of sale of a bond issue (actually or constructively received), together with the investment earnings thereon (actually or constructively received), (2) “discount proceeds,” which apparently will arise under circumstances where the bonds do not pay interest currently (e.g., zero coupon bonds) and (3) “transferred proceeds” with respect to a refunding issue which arise when proceeds cease to be refunded issue proceeds and become “transferred” proceeds of a refunding issue. Rebate Regulations Section 1.148-8T(d)(2).

The definition of the term “gross proceeds” is incomplete, however, because certain terms that are cross-referenced in the “gross proceeds” definition have been reserved. Statements in the Preamble (at pages 58 and 59) indicate what the ultimate definition of “gross proceeds” may be but are not definitive.

The absence of an adequate definition of “gross proceeds” is one of the main reasons that the Rebate Regulations are difficult to implement. Until this definition is clarified, issuers and their counsel will be subject to much uncertainty no matter how simple the method of rebate calculation may become once proceeds and allocable investments have been identified. While a systematic review of all the gross proceeds rules is beyond the scope of this report, several observations based on experience with prior definitions of “proceeds” seem in order.

Expansion of the concept of “proceeds” to include pledged funds and sinking funds seems to have provided the IRS and Treasury with sufficient authority to deal with most potentially abusive situations in this area. The rebate regulations under prior law seemed to confirm this implicitly because they did not add any significant new category of proceeds to the already established ones. Since prior law appears to have granted the IRS and Treasury the authority they needed, the new Rebate Regulations ought to change the scope of the definition as little as possible in the interest of fostering continuity and certainty.

Using this approach, notwithstanding the references in the legislative history to the contrary, the commingling exception should continue in the interest of providing simplified methods of accounting; i.e., the term "proceeds" should exclude investment proceeds commingled with issuer general funds. This commingling exception added simplicity under the prior non-rebate arbitrage rules, was not abused and should not be changed. It should perhaps also be noted that the rebate regulations under prior law did not provide a commingling exception for investment proceeds and were criticized for this omission. The need for the exception under the prior rebate regulations in the case of what were essentially all revenue bonds was much less pressing than currently when the rebate rules will apply to general obligation bond issuers that may find it much more difficult to track specific items of revenue and earnings.

Another generally accepted principle under prior law was that proceeds of one issue could not at the same time be proceeds of another issue (the "single issue rule"). The rebate regulations under prior law did not specifically include such a rule and there was some concern that when pre-1986 Act and post-1986 Act issues were issued under a parity indenture, proceeds of the pre-1986 Act issues in a debt service reserve fund were potentially subject to rebate because they were also pledged to post-1986 Act issues. Neither the text nor the examples in the Rebate Regulations specifically address the single issue rule, although the implication is that such a rule does exist. Some affirmation in the final regulations is requested that this rule does apply. The single issue rule is one designed to produce certainty. It has worked, it has not been abused and it should be retained.

The rebate regulations under prior law contained another ambiguity that elicited comment. These regulations referred to other amounts "used" to pay debt service aside from amounts held in a sinking fund. A question was raised what these other amounts were and whether the issuer of a revenue bond was required to rebate in respect of revenues used to pay debt service from the moment they were deposited in a revenue fund and not merely from when they were deposited in a fund expected to be used to pay debt service. The complexities raised by such an approach in the context of revenue bonds are greatly magnified for a general obligation bond issuer. The rule should be that gross proceeds, other than original and investment proceeds, should not be subject to rebate until their expected use is clearly identified (i.e., they are transferred to a fund or account specifically associated with the payment of debt service). This rule will recognize an existing practice which has developed as a result of administrative necessity. As concerns so-called "negative pledge" funds and general funds subject to liquidity covenants, such amounts should be considered outside the scope of "gross proceeds" so long as the bondholders have no rights which are superior to those of general creditors of the obligor.

Another potential question involves issuer fees. Announcement 85-174, recognized that despite the technical wording of the rebate regulations under prior law, administrative or issuer fees paid to an issuer would not be treated as "gross proceeds." The intent seems to have been that the payment would be treated as an expenditure for purposes of compliance by the borrower with the six-month safe harbor. In addition, any investment of such fees would not be subject to the Rebate Requirement. The definition of “original proceeds” under Rebate Regulations Section 1.148-8T(d)(3) includes amounts received with respect to a purpose investment in excess of one-eighth of one percent above the bond yield under Treasury Regulation Section 1.103-13(b)(5)(i)(A) (See discussion at Part 11(1), below). This definition directly contradicts the rule established in Announcement 85-174 which issuers have relied upon for the past four years; the definition in the final regulations should adopt the Announcement position.

6. Meaning of the Term “Reserve or Replacement Fund”.

The definition of the term “reserve or replacement fund” has been reserved in the Rebate Regulations although the Preamble provides a glimpse of what that definition may provide. Certainly, reasonably required reserve and replacement funds will be a subset of the definition. The Preamble (at page 33), in the context of special rules for restricted escrows, states that “[a]mounts to be used to pay debt service are not part of a reasonably required reserve or replacement fund unless the purpose of the fund is to cover a temporary shortfall in revenues (or the fund is a bona fide debt service fund).” The Preamble goes on to provide (at page 58) that “reserve or replacement funds” include (i) certain pledged and sinking funds that are treated as proceeds under prior law and (ii) proceeds indirectly pledged to pay debt service on the issue. This definition of “reserve and replacement fund” is broader than the prior law definition of a reasonably required reserve and replacement fund.

Under prior non-rebate arbitrage rules, the definition of a “reasonably required reserve or replacement fund” has developed over several years and includes a fund established to cover a temporary shortfall in revenues and a fund established to replace depreciable or obsolete items or to provide intermittent repairs. Treas. Regs. Section 1.103-14(d). As with so many other terms and definitions that have acquired an established meaning under the arbitrage rules, the Committee recommends retaining these established terms and definitions unless the Treasury believes there are compelling reasons to the contrary. To the extent this definition is changed by the regulations promulgated on this subject, the changes should be applied only prospectively.

The definition of reserve and replacement fund should not include direct and indirect sinking funds and pledged funds. In this regard, the Committee believes there is no statutory justification to impose the 10% deposit limitation prescribed by section 148(d) on sinking fund and pledged fund proceeds (See LTR 8923069). Imposition of such a limitation by expansion of the definition of the term “reserve or replacement fund” would have significantly adverse consequences as many States are using or contemplate using large sinking funds in connection with their EPA State Revolving Loan Fund programs. In summary, the Committee believes that such a size limitation is inappropriately dealt with under the Rebate Regulations.

7. Meaning of The Term "Discount Proceeds".

As in the case of the definition of "reserve and replacement fund," the definition of "discount proceeds" is reserved. However, the Preamble (at page 58) states that:

> "[D] Discount proceeds may arise in certain cases if the amount of outstanding bonds substantially increases during the term of the issue because the bonds do not pay interest currently. If discount proceeds arise, the proceeds would be allocated to investments or expenditures as appropriate."

Conceivably, "discount proceeds" may arise after the date of issuance of the discounted bonds in any case where revenues, otherwise available to pay debt service on the issue, are invested in taxable investments. Although not fully articulated in the Preamble, there seems to be a concern that the failure to pay debt service involves a replacement in which funds are invested rather than used to pay current debt service. The Committee is aware of certain instances that may be abusive, e.g., the issuer defers debt service by means of zero coupon obligations and uses the revenues which become available to invest in investment property. Aside from such specifically identified abuses, there is no justification for further imposing limits on an issuer's expenditures, or on the structure of its debt service. Issuers can have perfectly valid reasons for deferring the payment of debt service.

In view of the breadth and ambiguity of the above-quoted Preamble statement, the Committee requests further explanation concerning the types of transactions intended to be addressed by this category of proceeds. Due to the potential far reaching impact of this definition (particularly its impact on many State college savings programs) and difficulties in its application with any degree of administrative certainty, the Committee believes that a bond should not have "discount proceeds" allocated to it in circumstances where based on the facts and circumstances existing on the date of issuance of the bonds, the issuer has not designed the debt service schedule to make revenues available in an amount equivalent to the discount for the purpose of investing in investment property at any time during the term of the bonds. An objective measure for purposes of determining whether the debt service deferred is extraordinarily large is to be found in the imputed proceeds rules with respect to industrial development bonds. Treas. Reg. Section 1.103-8(a)(6) and (7).

8. <u>Necessity for General Rules for Allocating Proceeds to an Issue, Investments and Expenditures</u>.

The Rebate Regulations themselves have not provided critically needed rules for allocating gross proceeds to an issue, investments and expenditures. In the absence of any guidance, the Preamble states on page 59:

> "[i]f proceeds are used directly or indirectly, the proceeds are treated as used directly or indirectly (whichever produces the larger amount of rebatable arbitrage).... [A]n indirect use occurs if fully fungible dollars are substituted for other fully fungible dollars solely for tax reasons, and the substitution involves a change in the purpose for which the funds are to be used."

The above-quoted “indirect use” rule acknowledges that “proceeds” may have multiple uses, appearing to suggest that proceeds are allocated according to their original purposes. If the test is to be applied on the basis that any business or statutory reason will avoid a “solely for tax reason” result, then we suggest this test is no different than general tax principles where substance controls over form and the insertion of this clause weakens the general substance over form analysis that should be applied. Furthermore, any application of this rule is impossible or difficult at best, when proceeds of multiple bond issues with multiple purposes are pooled for purposes of investment and expenditure, or when other funds are available from sources other than bond proceeds to be used for the purposes of the issue. The Committee recommends that this “indirect use” rule be clarified in the text of the final regulations to the extent such rule applies at all.

While page 14 of the Preamble says any allocation rules adopted will accommodate customary governmental accounting practices to the extent possible, the lack of any safe harbors in the Preamble encourages an overpayment of rebate. The Committee recommends that issuers be permitted to rely upon consistent (from year-to-year) expenditure patterns, and accounting allocation conventions and rules to track proceeds, investments and expenditures.

9. Hedging Transactions Generally.

The Preamble states that hedging transactions may have an impact on yield and indicates that a fixed-to-floating interest rate swap executed on the same date that fixed yield bonds are issued may be integrated with the fixed yield bonds to create a variable yield issue. A similar possible result is indicated in the case of caps, collars and other otherwise unidentified hedging transactions.

The position taken by the Preamble seems contrary to the prior IRS position in the State of Washington[*] case that yield is to be determined by what is paid and received by bondholders, not the cost of an issue to an issuer. Congress expressly overruled the State of Washington case in the 1986 Act and impliedly adopted the IRS position in that litigation. There seems to be a lack of authority, therefore, for the rule indicated in the Preamble. In light of the prior IRS position, any change (the correctness of which the Committee reserves the right to comment upon) ought to be prospective from the date that an implementing regulation or notice is published.

[*] State of Washington v. Commissioner, 77 T.C. 656, aff'd 692 F.2d 128 (D.C. Cir. 1982).

If integration of transactions is adopted, it would require a parity of treatment between fixed-to-floating interest rate swaps and floating-to-fixed interest rate swaps. Integration should only be required in the case of an almost simultaneous interdependent execution of a swap and the issuance of bonds. A bright-line safe harbor of 30 days or some longer period should be provided to issuers that would offer a conclusive bar against integration in the absence of some underlying arrangement. A facts-and-circumstances approach would be difficult to administer and, as in the composite issue area, some period of separation should be recognized as making a transaction “old and cold.” Subsequent renewals which are subject to negotiation at the time of renewal should be addressed in light of the ability of the issuer to redeem the debt at or about that time.

The need for a bright-line test is underscored by the anomalous results that would occur if integration could occur whenever a swap was executed. First, there is a difficulty in allocating a swap when an issuer has multiple issues outstanding. In such a situation, an issuer is swapping against an undifferentiated debt service, not a specific issue, and any allocation rules would seem to be arbitrary and lack a sound economic basis. Second, the Rebate Regulations themselves seem to be drafted on the assumption that a fixed yield issue cannot subsequently become a variable yield issue. If, however, a fixed-to-floating interest rate swap can at any time cause an otherwise fixed yield issue to become a variable yield issue, then a fixed yield issue will always have the potential of becoming a variable yield issue. The problem would seem less acute for a variable yield issue because swaps ordinarily have a term that is substantially shorter than the term of a bond. Thus, the potential for an issue to return to variable yield status at the termination of a swap would seem to keep the issue a variable yield one even when the swap is in place.

A subsequent notice or regulation should define what constitutes a hedging transaction by offering more than examples of specific types of products. Many provisions of the Rebate Regulations deny the benefit of certain rules when issuers have entered into hedging transactions, and issuers should have a basis for determining whether new products will cause them to forego these benefits. In addition, reversals and the payments made in connection with them should be addressed. Swaps are not ordinarily cancelled when a party wishes to unwind a position either because interest rates have changed or for other reasons. Instead, the party wishing to unwind will enter into an offsetting swap that effectively cancels out future payments to its counterparty in return for a current lump sum payment to, or from, the counterparty. Since payments made in connection with reversals are dependent on circumstances, such as interest changes unrelated to the original issuance of the bonds, they should be excluded from yield calculation, just as the Rebate Regulations exclude from yield calculation premiums paid when bonds are retired.

10. Hedge Bonds for Single Borrowers.

The Preamble states (on pages 48 and 49) that "[i]issuers should be aware, however, that the issuance of callable bonds for the primary or sole purpose of hedging against a rise in interest rates may violate, inter alia, the 10-percent reserve or replacement fund financing limitation added by the 1986 Act." This is probably an inaccurate conclusion and, in any event, the problem is inappropriately and insufficiently dealt with in the context of the Rebate Regulations. Although Congress did not specifically deal with single borrower bonds or pools in the Technical and Miscellaneous Revenue Act of 1988 ("1988 Act"), Treasury was directed in such Act to "report to the Committees on Ways and Means and Finance any abuses that it finds, including the excessive issuance of tax-exempt bonds in pool-bond type arrangements." H.R. Rep. No. 100-1104, 100th Cong., 2d Sess. at 123. The Committee believes the Preamble is not the appropriate place to address the Treasury Department's response to Congress because it is too indirect and does not allow the conclusion to be examined.

11. Replacement.

As our comments concerning "discount proceeds" indicate, the Preamble hints at a broadening of the concept of replacement in order to deal with potentially abusive situations. For example, on page 62 of the Preamble, it is suggested that the freeing up of pledged funds in connection with a refunding may give rise to a replacement, similarly on page 64, the new transferred proceeds rules are justified because they “more accurately reflect” the economics of replacement. We would urge that less concern be devoted to the derivation of rules based on theoretical ideals and more to providing issuers with practical administrative guidance. For two decades the public finance community has awaited the promulgation of regulations defining the term “replacement”; instead of issuing regulations, the Treasury has relied on the absence of a definition as a self-policing mechanism. Unfortunately, self-policing relies on the intended or unintended conclusions of many individuals. The Committee recognizes that while the IRS and Treasury have to deal with abusive transactions, the trade-off is that anti-abuse rules drafted in generic terms add complexity and uncertainty. Any expansion of the concept of replacement should be deferred until the IRS and the Treasury Department - issue regulations defining the term “replacement” or after the need for immediate guidance has arisen.

PART II. COMPUTATION OF REBATABLE ARBITRAGE

1. Scope of the Rebate Regulations - Acquired Program Investments.

The regulations under prior law permitted a 150 basis point spread between acquired program obligations and the bond yield. The IRS took the position that an issuer had an option of either recovering costs plus 1/8 of one percentage point spread over the bond yield or of paying program costs out of the 150 basis point spread over the bond yield. Rebate Regulations Section 1.148-8T(d)(3) requires amounts received with respect to a purpose investment in excess of the 1/8 of one percentage point spread under Treasury Regulations Section 1.103-13(b)(5)(i)(A) to be included within the definition of “original proceeds.” Original proceeds are part of “gross proceeds” subject to rebate.

Comments:

The new Rebate Regulations rule could cause an issuer to inadvertently violate the six-month exception (or the Expenditure Exception, if enacted into law). By including amounts received in excess of one-eighth of one percent within the definition of “original proceeds,” the Rebate Regulations contradict Announcement 85-174 which excludes issuer fees from gross proceeds. Issuer fees are typically used by the issuer to pay its own administrative costs and to subsidize other governmental programs. The situation does not involve any apparent abuses, and the Committee is therefore concerned that any attempt to address it may result in expenditure concepts that are difficult to administer. If the definition is not modified to be consistent with Announcement 85-174, then whether amounts cease to be gross proceeds through an expenditure should involve a straightforward determination that the payor no longer has an interest in, or control over, the use of proceeds regardless of the payee's identity.

Given reliance by issuers upon Announcement 85-174, there are numerous ongoing governmental programs that have been structured based on the premise that the issuer fees are deemed spent upon receipt. Announcement 85-174 expressly states that final rebate regulations will clarify that amounts paid to issuers as administrative or issuer fees are not subject to the Rebate Requirement. To the extent that there are outstanding acquired program obligations or ongoing programs that have been structured in reliance upon the rule set forth in Announcement 85-174, the final regulations should at least provide transitional relief for such programs or such obligations.

2. Future Value Method.

The Rebate Regulations require the amount of the rebate to be computed using a “future value” method. The rebatable arbitrage with respect to a bond issue as of any computation date is equal to the excess of the future value of all non-purpose receipts with respect to the issue over the future value of all non-purpose payments. All of these receipts and payments are “future valued” using the basic formula, FV= PV (1+i)n, where “FV” is the future value of the non-purpose receipt or payment at the end of each compounding interval (which is the same as the interval used in computing the bond yield); “PV” is the future value of the non-purpose receipt or payment at the beginning of each interval with the first interval beginning on the date the non-purpose receipt or payment is actually or constructively received or paid; “i” is the yield on the bond issue during the interval; and “n” is a fraction, the numerator of which is the length of the interval, and the denominator of which is the length of a whole compounding interval. Rebate Regulations Section 1.148-2T(c)(1).

Comments:

Generally, the Committee endorses the future value method because it offers a straightforward method of computing rebatable arbitrage. In describing the application of the future value method, the Preamble contains several examples (pages 24 through 27) that the Committee recommends should be incorporated into the final Rebate Regulations with revisions concerning transaction costs noted in the next subsection.

The Committee recommends, however, the following changes in the Preamble examples of the future value method: (i) for the reasons set forth under point 3(a) below, the non-purpose receipts and non-purpose payments (or reinvestments) should be reduced or increased, respectively, to specifically allow customary transaction costs (e.g., actual brokerage commissions ordinarily charged); and (ii) the examples should also clarify the circumstances in which amounts that are not in fact reinvested immediately (due to unanticipated delays in the ordinary course of business) are "deemed" reinvested immediately.*

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* The Committee points out that most, if not all, computer spread sheet programs and handheld financial calculators do not have a function that calculates yield accurately when a short period is involved. As a consequence, these regulations require separate programming ability in order to enable compliance.

3. Non-purpose Receipts and Payments.

(a) Transaction Costs.

For purposes of determining non-purpose receipts or payments, any amount actually or constructively received or paid with respect to an investment allocated to an issue must be taken into account. The Rebate Regulations provide that amounts are “constructively” received or paid where (i) investments cease to be allocated to an issue under the definition of “disposition receipts” and (ii) an investment not directly purchased with gross proceeds of the issue is allocated to such proceeds under the definition of “constructive payments.” Rebate Regulations Section 1.148-2T(b)(2)(ii) and (b)(3)(ii).

Comments:

The Rebate Regulations provide that non-purpose receipts and payments are not reduced by brokerage commissions, administrative expenses or similar expenses. This rule artificially increases the amount of rebate payable by issuers and directly contradicts what the Committee believes should be the overall policy of the Rebate Regulations -- to accurately reflect the economics of a transaction in determining the amount of rebatable arbitrage.

It should be noted that Section 148(f)(4)(A)(i) of the Code provides merely that in determining the amount earned on non-purpose investments, “any gain or loss on the disposition of a non-purpose investment shall be taken into account,” without any reference to disregarding transaction costs. A long line of judicial decisions, following Soreckels v. Helvering.

315 U.S. 626 (1942), have uniformly held that, for the purpose of determining the amount of gains and losses derived from dealings in property (including both securities and real estate transactions), brokerage commissions should be added to the cost of, or subtracted from the selling price of, the capital asset being purchased or sold, thus reducing the gain (or increasing the loss) realized from the transaction. There is nothing in Section 148(f) of the Code or in the Conference Report to the 1986 Act that indicates an intent by Congress to revise that long-established rule.

The present rule in the Rebate Regulations penalizes an issuer for no apparent policy reason any time it rearranges or reinvests its portfolio because transaction costs cannot be recouped. The final regulations should permit issuers to reduce receipts and increase payments by the amount of customary and reasonable transaction costs. Any attempt on the part of any participant involved in a transaction to artificially increase costs or decrease rebatable arbitrage by means of transaction costs that are not customary could be addressed as part of the forthcoming imputed receipts rules.

(b) Eligible Investments.

The Rebate Regulations require that investments be valued at fair market value under circumstances where receipts and payments are “deemed to occur,” such as investments which: (1) cease to be allocated to a bond issue other than by reason of a sale or disposition (e.g., investments no longer pledged to pay debt service); (2) become allocated to a bond issue although not originally purchased directly with gross proceeds of an issue (e.g., investments pledged to pay debt service after their original purchase); (3) are allocated to a bond issue as of a computation date; and (4) constitute “imputed receipts.” Rebate Regulations Section 1.148-2T(b). Any recovery of rebate overpayments or any timely payments (including corrected payments) of rebate are treated as receipts or payments, respectively, for this purpose.

In determining the non-purpose receipts deemed to occur on an installment computation date, the Rebate Regulations permit fixed rate investments to be valued by computing the present value of all the receipts to be received with respect to the investments after such computation date using the yield on the investment at the time it was first allocated to the issue as the discount rate (the “Present Value Rule”). Rebate Regulations Section 1.148-2T(b)(2)(ii). See the discussion under Section 5. of Part III for the formula used in determining present value. For purposes of this Present Value Rule, an issuer is entitled to treat the outstanding par amount of an investment (plus unpaid accrued interest to the - computation date) as the present value of the investment on such date, provided the investment is an “eligible investment.” The Rebate Regulations define an “eligible investment” as a fixed rate investment that is not a U.S. Treasury Obligation -- State and Local Government Series (“SLG”) or part of a restricted escrow, and with respect to which:

(I) the payment taken into account concerning the investment is equal to the outstanding par amount of the investment plus accrued interest (if any) for the period that begins on a date that is less than one year before the date the investment is allocated to the bond issue and that ends on the date the investment is allocated to the issue;

(II) all interest on the investment (other than the accrued interest referred to in I) accrues on the outstanding par amount of the investment and is actually and unconditionally due at periodic intervals of one year or less;

(III) the first payment of interest on the investment (including the accrued interest referred to in I) is due at the end of the first whole or partial compounding interval; and

(IV) the final maturity date of the investment is the date on which the investment is retired at a stated price that, when used in computing the yield on the investment, produces the highest yield. Rebate Regulations Section 1.148-2T(e)(5).

Comments:

The Committee recommends that the final regulations contain a definition of an "eligible investment" that includes an investment with a *de minimis* amount of discount or premium (*e.g.*, equal to or less than the greater of (i) two percent or (ii) the number of years to maturity multiplied by one-quarter of one percentage point).

4. Computation Date Credits.

The future value of the non-purpose receipts and payments is computed as of each computation date, which includes each installment computation date (the last day of the fifth and each succeeding fifth bond year) and the final computation date (the date the last bond that is part of the issue is discharged). Rebate Regulations Section 1.148-8T(b)(1). The term "bond year" means each one-year period (or shorter period from the date of issue) that ends at the close of business on the day in the calendar year that is selected by the issuer. The date selected by the issuer must be the last day of a compounding interval used in computing the yield on the issue. Rebate Regulations Section 1.148-8T(b)(2). The Rebate Regulations permit an issuer to offset rebatable arbitrage on each computation date with a computation date credit ("Computation Credit") measured by the size of the bond issue:

> (I) $1,000, where the aggregate issue price of the bonds issued and outstanding immediately before the computation date is more than $5 million;
>
> (II) $625, where the aggregate issue price of the bonds is more than $1 million but not more than $5 million; and
>
> (III) $250, where the aggregate issue price of the bonds is not more than $1 million. Rebate Regulations Section 1.148-2T(b)(4).

Comments:

Rebate Regulations Section 1.148-2T(b)(4)(iii) requires at least one year to elapse between computation dates for a computation date to be "eligible." There should be an exception to this rule for commercial paper financings that reduces this time period to between three and six months. In addition, a final computation date within one year of the prior computation date should be eligible for the Computation Credit.

The Committee believes that the dollar amount of the Computation Credit should not be dependent upon the original issue size or the amount of bonds outstanding over the term of the issue. The computation of rebatable arbitrage could be as complex for a $4,000,000 bond issue as a $40,000,000 bond issue.

Furthermore, the size of the Computation Credit is so de minimis in relation to the cost of time and money involved in computing rebate that it is meaningless to issuers and should be significantly enlarged.

The amount of the Computation Credit is treated as a non-purpose payment with respect to the bond issue on the computation date. For a Computation Credit to be received by an issuer on a computation date, such date must be at least one year after the immediately preceding computation date and at least 75% of the net sale proceeds of the bonds must be allocated to expenditures (other than expenditures for the payment of debt service on the bonds) by such date. Rebate Regulations Section 1.148-2T(b)(4)(iii). For this purpose, the term “net sale proceeds” means amounts actually or constructively received from the sale of the bonds less proceeds that are (1) part of a reasonably required reserve or replacement fund, (2) used to pay accrued interest included in the issue price of the bonds within one year from the date of issue, (3) used to pay capitalized interest that accrues on the bonds within three years from the date of issue and (4) sale proceeds received with respect to an acquired purpose investment that are allocated to an expenditure no later than thirteen months after the date of receipt. Rebate Regulations Section 1.148-8T(d)(6).

The Committee believes that eligibility for the Computation Credit should not depend upon the expenditure of net sale proceeds because there may be reasons beyond the control of the issuer that cause this requirement not to be met. Accordingly, the Committee recommends that the expenditure requirement referred to in the previous paragraph be deleted from the final regulations.

5. Fair Market Value Determinations.

The Rebate Regulations contain guidelines for determining the fair market value of investments. In general, the "fair market value" of an investment is the price at which (i) a willing buyer would purchase the investment from a willing seller, or (ii) if an investment is not readily salable, the price at which a willing buyer would purchase the same (or a substantially similar) investment from the issuer of the investment. Rebate Regulations Section 1.148-2T(d). The Rebate Regulations contain special rules for valuation of investments traded on an established securities market and investments backed by the full faith and credit of the United States or any agency or instrumentality thereof.

Comments:

The rules for determining "fair market value" in the Rebate Regulations are different from, and to some extent are inconsistent with, the market price rules (the "Market Price Rules") set forth in Treasury Regulations Section 1.103-13(c)(1)(iii)(B). Those rules are designed to ensure that investments are purchased for fair market value in the context of yield restricted funds.

The fair market value rules contained in Rebate Regulations Section 1.148-2T(d)(1) include investments that are not readily salable unlike the Market Price Rules which are limited to investments for which there is a secondary market.

Where investments are readily traded on an established securities market, Rebate Regulations Section 1.148-2T(d)(2) provides that the rules set forth in Estate Tax Regulations-Section 20-2 031-2 shall apply. These estate tax valuation rules are much more complex than the Market Price Rules for readily traded securities. For example, the Market Price rules provide that the market price of an acquired obligation is the mean of the bid and offered prices on the date of issue of a refunding issue or, if earlier, on the date of a binding contract to acquire such obligation, or, if there are no bid and offered prices on such date, on the first preceding date that there were such prices. Treasury Regulations Section 1.103-13(c)(1)(iii)(B). By contrast, Estate Tax Regulations Section 20.2031-2(b) requires, where there are no sales on the valuation date, that the fair market value be determined by taking a weighted average of the mean between the highest and lowest sales on the nearest date before and nearest date after the valuation date (assuming there are recent trades). If there are not recent trades, the estate tax rules continue by providing a series of other rules which apply, depending on the facts and circumstances.

Although the Rebate Regulations do not limit application of Estate Tax Regulations Section 20.2031-2, certain members-of the public finance community have been informed by Treasury Officials that these valuation rules only apply in circumstances where there is a “deemed” sale, as opposed to an actual sale, for purposes of computing receipts and payments under the Rebate Regulations. Thus, the estate tax regulations would apply on a computation date for purposes of determining the fair market value of non-purpose investments allocable to gross proceeds that have not been actually sold. Presumably, the Market Price Rules apply for purposes of determining fair market value of purchases and sales for arbitrage purposes, and the new, as yet reserved, imputed proceeds rules apply to acquisitions and actual sales for rebate purposes.

Reference to yet a third set of market price rules for purposes of determining fair market value where there are “deemed” purchases and sales is unnecessary and adds complexity for no apparent policy reason. Instead of multiplying the number of different rules, the Committee recommends the use of a single set of market price rules to avoid unnecessary confusion among issuers and to promote simplicity and to increase uniformity among issuers concerning compliance.

PART III. COMPUTATION OF YIELD ON THE BONDS

1. Overview.

In order to determine the rebatable arbitrage according to the future value method described in Section 2. of Part II, above, the issuer is required to first compute the bond yield. The future value of the cash flows composed of non-purpose receipts and payments are determined by using the bond yield as the compound or future valuation rate. The yield computation rules set forth in the Rebate Regulations are much more complex than the corresponding rules under Treasury Regulations Section 1.103-13(c) because the new rebate rules contain separate requirements for many different types of bonds, such as fixed rate, variable rate and yield-to-call bonds.

The Rebate Regulations distinguish between variable yield bonds and fixed yield bonds. The term “variable yield bond” means any bond if any interest or other amount payable on the bond (other than in the event of an unanticipated contingency) is determined by reference to (or by reference to an index that reflects) market interest rates or stock commodity prices after the date of issue. Rebate Regulations Section 1.150-1T(b)(6). Variable yield bonds may be obligations that are “tender bonds” -- obligations which in general are subject to a “tender right,” i.e., the right of a holder to tender the bond for purchase or redemption at par on specified dates (“tender dates”) before the final maturity date (plus accrued interest to the tender date if the tender date is not a regular interest payment date). Rebate Regulations Section 1.150-1T(b)(7). Variable yield bonds may also be “current index bonds” if (i) all interest on the bond (other than in the event of a remote contingency) accrues at the current rate established by a single interest index or at a rate that is fixed and determinable as of the date of issue and (ii) such interest is actually and unconditionally due at periodic intervals of one year or less. Rebate Regulations Section 1.150-1T(b)(8). Obligations other than “variable yield bonds” constitute “fixed yield bonds.” Rebate Regulations Section 1.150-1T(b)(5).

Comments:

The Committee recommends clarification of the interaction between the special rules set forth in Section 143 of the Code, relating to single family mortgage revenue bonds, and the yield computation rules contained in the Rebate Regulations and discussed herein below. For example, Code Section 143(g)(2)(C)(ii) requires yield on single family mortgage revenue bonds to be computed based upon the assumption that the bond will mature in a manner that is consistent with the most recent Federal Housing Administration mortgage prepayment experience. The Rebate Regulations do not adopt this special rule in determining the assumed retirement date in calculating yield on this type of obligation.

2. Bond Yield-General Rule.

Rebate Regulations Section 1.148-3T(b)(5)(i) defines the term “yield” with respect to a bond as the discount rate that when used in computing the present value of all unconditionally payable payments of principal and interest and all the payments for a qualified guarantee (discussed below) paid and to be paid with respect to a bond produces an amount equal to the present value of the issue price (discussed below) of the bond. The present values are computed as of the date of issue of the bond.

Comments:

The new methodology prescribed by the Rebate Regulations for determining “yield” with respect to fixed yield bonds applies for arbitrage purposes, generally, as well as for rebate purposes. See Rebate Regulations Section 1.148-9T(a). However, the new methodology prescribed by the Rebate Regulations for purposes of computing “yield” with respect to variable yield bonds does not apply for arbitrage purposes as well. As discussed in subsection 3. of “Background and Overview,” above, the Committee recommends applying the new Rebate Regulations' yield rules applicable to variable yield bonds for both rebate and arbitrage purposes.

3. Issue Price.

Under the Rebate Regulations, the “issue price” of a publicly offered issue is determined on the basis of the initial offering price to the public at which price a substantial amount of the bonds are sold to the public. The issue price of each maturity of the bonds is determined separately. The issue price of bonds that are not substantially identical that are sold to the general public must be determined separately. Rebate Regulations Section 1.148-8T(c)(1). For bonds that are publicly offered, the issue price is based upon the actual facts and reasonable expectations as of the sale date, i.e., the first day on which there is a binding contract in writing for the sale or exchange of a bond on specific terms that are not materially altered thereafter. For bonds offered at one price to the general public and at a discount price to institutional or other investors, the issue price of each bond is the average offering price of all bonds. Rebate Regulations Section 1.148-8T(c)(2)(ii), as amended by Advance Notice 89-78.

Comments:

In order to calculate the yield on a bond, one must first determine its issue price. Because the yield calculation generally, consists of the present valuation of the debt service on a bond to an initial target amount which consists of the issue price plus accrued interest on the bond, the result is that the lower the issue price, the higher the bond yield and vice-versa. Prior to the Rebate Regulations, issue price for publicly offered bonds was determined under Section 1273 of the 1986 Code on the basis of the initial offering price to the public (excluding bond houses, brokers and dealers) at which a substantial amount (interpreted to mean 10%) of each maturity of bonds was sold. The prior rules did not distinguish between sales to the general public or to institutional investors in determining issue price.

The Rebate Regulations provide a benefit to issuers of bonds in that they require that any bonds sold to “institutional investors or other investors” at a discount from the price at which bonds of the same maturity are sold to the general public have their prices averaged in with the price at which a substantial amount of the non-institutional bonds are sold to the general public. This averaging calculation serves to lower the issue price and, as noted above, increases the bond yield. Rebate Regulations Section 1.148-8T(c)(2) seems to provide that issue prices shall be determined based on reasonable expectations on the date bonds are sold but that the amount of bonds sold to the general public and the amount sold to institutional investors is to be determined based on reasonable expectations as of the date of issue. To confirm this interpretation, it would be helpful to illustrate these rules with an example.

The Committee believes, however, that the manner in which issue price is determined under the Rebate Regulations, is confusing and needs to be clarified. One point relates to the Rebate Regulations stating that issue price is to be determined separately for bonds that are not “substantially identical,” without defining that term. The examples in the Rebate Regulations infer that bonds are substantially identical if they have the same maturities and coupons. This corresponds well to the prior law approach under which issue price was determined separately for each maturity. The Rebate Regulations should therefore specifically define “substantially-identical” bonds to be those having the same maturities and coupons.

A second point is the Rebate Regulations providing that bonds offered to the general public in a bona fide public offering in which no such bonds are also offered at a discount to institutional investors shall have their issue price determined on the basis of “actual facts and reasonable expectations” as of the sale date of the bonds. Rebate Regulations Section 1.148-8T(c)(2)(i). It may be that the Rebate Regulations intend that in the case where no bonds are offered to institutional investors at a discount, the bond will have the issue price reasonably expected on the sale date (regardless of whether a “substantial amount of the bonds was sold to the public” at this price) while for bonds purchased at a discount by institutional investors, the issue price is based on the date of issue. The Committee recommends that the final regulations provide clarification on this point.

A third point is the language used in Section 1.148-8T(c)(2)(iii) of the Rebate Regulations. It appears to state that the issue price must be based on actual facts for any bonds not actually offered to the general public but is confusing and should be rewritten to make its point more clearly.

If the necessity of determining the actual sale prices to the general public is not deleted in the final regulations, then the Rebate Regulations should be clarified as to the amount of diligence issuers should exercise in determining issue price. For example, it is often the case that bonds are sold to brokers who may not have resold the bonds to the public as of the date of issue. In such circumstances, the Rebate Regulations (if read strictly) would require issuers to question the brokers as to their reasonable expectations and the actual sale prices. In many cases, it might not be possible to question all brokers prior to the date of issue. The final regulations should therefore make it clear that such diligence is not compulsory but rather is an option available to issuers seeking to maximize the yield on the bonds.

The Rebate Regulations also state that for bonds sold to the public after the date of issue, the price at which such bonds are sold must be adjusted to reflect the price at which such bonds would have been sold on the date of issue. The Committee assumes the intention is that once the issue price has been determined on the closing date, it will not be adjusted as a result of subsequent sale. If this is the intention, the language of the regulations should be revised to state that point more clearly.

Finally, the Committee recommends that the Rebate Regulations clarify the manner in which the discount on bonds sold to institutional or other investors is determined. For example, if substantially identical bonds are sold to the general public at prices of 100% and 98%, and are sold to institutional investors at 99%, it is unclear whether the bonds sold to institutional invest-ors are treated as sold at a discount from bonds sold to the general public. The final regulations should specifically state whether or not the institutional bonds have to be sold at a discount from any substantially identical bonds sold to the general public in order to have their issue prices determined in a different manner. As noted above, this added burden could be avoided in the event the final regulations eliminate the necessity to determine actual sale prices to the general public, but rather, rely upon reasonable expectations.

Rebate Regulations Section 1.148-8T(c)(3) establishes a "fair market value limit" under which the issue price of a bond determined under the rebate issue price rules may not exceed the fair market value of the bond as of the sale date. This fair market value provision creates an unintended result. The issue price for an obligation bears an inverse relationship to the yield on such obligation. As a consequence, this provision would require the yield to be increased above the yield on the bonds based upon the actual sale price to the issuer if the price of a bond declined between the date of pricing and the date of actual sale. The Committee recommends that this rule be revised to provide that the issue price is to be reduced by any decrease in the sale price between the date of the pricing and the actual sale date where the loss is borne by the issuer and not the underwriter.

4. Stated Retirement Price.

For purposes of computing the yield on a bond, the "stated retirement price" of the bond on the assumed retirement date is treated as an unconditionally payable payment of principal and interest. Rebate Regulations Section 1.148-3T(b)(5)(i). The "stated retirement price" of a bond on a date is the lowest price at which the issuer or any ultimate obligor (or related person) has a right to retire or redeem the bond on that date under the terms of the bond or pursuant to a separate agreement or option entered into in connection with the issuance of the bond. A right to retire or redeem a bond exists even if it is contingent, so long as it is not remote (e.g., a right of redemption upon destruction or condemnation of bond-financed facilities). Rebate Regulations Section 1.148-3T(b)(6)(ii)(B).

The assumed retirement date for purposes of computing yield on a bond is generally the final maturity date, which is the latest date on which any principal or interest on the bond is actually and unconditionally due. Rebate Regulations Sections 1.148-3T(b)(5)(ii) and 1.150-1T(d)(1). However, in special situations such as bonds subject to mandatory sinking fund redemptions and callable bonds issued at a significant premium (see Sections 10. and 12. of this Part, below), a date earlier than the final maturity date will be used as the assumed retirement date. A payment of principal or interest is “actually and unconditionally due” on the first day on which the failure to make the payment on a timely basis results in significant remedies and consequences to the issuer that are normal in similar lending transactions. Rebate Regulations Section 1.150-1T(d)(2).

Comments:

As noted above, Rebate Regulations Section 1.148-3T(b)(6)(ii)(B) provides that the right of an issuer to retire or redeem a bond includes “contingent” rights. The final regulations should provide further guidance on when rights are “contingent” as opposed to “remote.” For example, the non-origination of mortgage loans due to a change in market conditions would ordinarily be within the meaning of “contingent.” However, for this purpose it must be treated as “remote?” otherwise all single family mortgage revenue bonds would mature after very short periods (e.g., one year) under this rule.

5. Fixed Yield Issues.

Under the Rebate Regulations, a “fixed yield issue” is an issue composed entirely of fixed yield bonds. The yield on a fixed yield issue as of any computation date is the discount rate that produces the same present value of all the (i) issue payments paid and to be paid in connection with the bonds and (ii) issue prices of the bonds. Rebate Regulations Section 1.148-3T(c). All of these issue payments and issue prices are “present valued” as of the date the bonds are issued using the basic formula, PV=FV/ (1+i)n, where “PV” is the present value of amounts to be received or paid; “FV” is the amount received or paid; “i” is the discount rate (or internal rate of return) divided by the number of annual compounding intervals; and “n” is the number of whole or partial compounding intervals during the period beginning on the date the present value is computed and ending on the date the amount is to be received or paid. Rebate Regulations Section 1.148-8T(b)(5). Generally, the Rebate Regulations require the yield on a fixed rate issue to be recomputed on any computation date if any bonds have been retired prior to their final maturity date.

Issue payments are divided into those that are paid on or before the computation date and those to be paid thereafter. The issue payments paid on or before the computation date include: (i) amounts paid to discharge principal or interest on the bonds (other than those in (ii) and (iii), below) and for a qualified guarantee (other than amounts taken into account in computing any payments in (iii), below), (ii) if any bond is retired on the final maturity date, the amount paid in connection with the retirement or redemption of the bond (the "Retirement Price"), and (iii) if any bond is retired before the final maturity date, an amount equal to the "Early Retirement Value," defined below. Rebate Regulations Section 1.148-3T(c)(2).

In the context of a fixed yield issue, Rebate Regulations Section 1.148-3T(b)(7) defines "Early Retirement Value" of a bond on the early retirement date as the lesser of (1) the present value of the bond on such date, and (2) if the yield-to-maturity on the bond is higher than the lowest yield, the lowest stated retirement price (adjusted for accrued interest) on any day during the period beginning one year before such date and ending 90 days after such date. For purposes of the foregoing rule, the present value of the bond on the early retirement date is the present value of all originally scheduled payments of principal and interest (and all payments for a qualified guarantee) to be paid on or after that date discounted at an interest rate equal to the yield-to-maturity on the bond (the "Exact Method"). Rebate Regulations Section 1.148-3T(b)(8)(i).

The issue payments that are taken into consideration in computing yield on a fixed rate issue, but that are not actually paid as of a computation date, include scheduled early retirements, such as a mandatory sinking fund redemption of term bonds or bonds to be retired before the final maturity date pursuant to a binding obligation that exists on a computation date (e.g., an issuer's contractual obligation to call on the first optional call date). Also, the early redemption of bonds to be called prior to final maturity with refunding issue proceeds must be taken into account if the refunding bonds have been issued on or before a computation date. Rebate Regulations Section 1.148-3T(c)(3)(i)(B). The Rebate Regulations contain special rules for computing the yield with respect to so-called “yield-to-call” bonds and bonds sold at a discount that are subject to mandatory early redemption, which are discussed in Sections 10. and 12., below.

Comments:

The Committee recommends the deletion from the final regulations of the rule that yield on a fixed rate issue be recomputed to take into account early retirements. First, this rule is not supported by the rationale contained in the legislative history for the adoption or the extension of the arbitrage rebate rules. The abuses that Congress and the Treasury Department were concerned with were the incentive that arbitrage provided to issue more bonds, to issue bonds earlier or to leave bonds outstanding longer than they otherwise would. In fact, the requirement that yield be recalculated to take into account early retirements may itself cause issuers to leave bonds outstanding longer than they otherwise would. In addition, neither the legislative history of the rebate requirement (in the Mortgage Subsidy Bond Tax Act of 1980, the Deficit and Fiscal Responsibility Act of 1984 or the 1986 Act) nor any of the rebate regulations issued under prior Code sections 103A(i) and 103(c)(6) specifically require that yield be recomputed to take into account early retirements. In each of the three acts that adopted or extended the arbitrage rebate requirement, changes were made to the calculation of yield and in none of those changes was there any indication that yield based on reasonable expectations did not continue to be the proper standard. The legislative history to the 1986 Act indicated that the rebate requirement was being <u>extended</u> and that Congress did not intend to affect principles of prior law which, to the extent not amended, continued to apply.

Second, the requirement that yield on fixed rate issues be recalculated to take into account early retirements adds a significant amount of complexity to an already complex set of regulations. Further, this complexity seems to be motivated more by a desire to issue a theoretically pure set of regulations than a desire to curb significant abuses. As the examples contained in Exhibit 1 demonstrate, the re-computation of yield, even without taking into account call premium, does not significantly alter the amount of the rebate. In light of the added complexity of both the additional computations and the need to explain to issuers the results of early retirements, we believe that re-computation of yield should not be required.

Third, the re-computation of yield will often present an additional practical problem for issuers. In many transactions all of the proceeds will have been spent many years before an early retirement occurs. In these situations, a re-computation of yield may result in an additional rebate being due where the issuer no longer has any bond proceeds on hand. This is the same problem that, in large part, led to the regulatory approach adopted for rebate on variable rate issues. For purposes of complying with generally accepted accounting principles applicable to governments, the computation of the potential outstanding liability for rebatable arbitrage under various assumptions regarding potentially lower bond yield-to-term could become extremely complex.

For these reasons, we believe the requirement that yield be recomputed to take into account early retirements should be deleted. The rules relating to yield-to-call bonds and discount term bonds address situations where bonds will not be retired at final maturity for their stated redemption prices. If necessary, special rules could be adopted for such situations that are likely to involve abuses (e.g., escrow transactions). At a minimum, the final regulations should provide some type of exception to the re-computation requirement where the early retirement occurs a significant period of time after the original bond proceeds (other than that portion in a reserve or replacement fund) have been spent.

Assuming that the requirement that yield be recomputed in the event of an early retirement is retained, the final regulations should permit call premium to be taken into account. This would accurately reflect the issuer's cost of funds and the economics of the transaction, unlike the current rule. The rules for calculating yield have long required that all payments of principal and interest be taken into account. Nothing in the legislative history to the Rebate Requirement indicates any intent to change these rules in this context. In addition, for

Federal income tax purposes, generally, redemption premium is treated as interest (see Treas. Reg. Section 1.163-3(c)(1)).

6. Eligible Bonds - Approximate Method.

If a bond is an "eligible bond," the issuer may treat the outstanding par amount of the bond plus unpaid accrued interest on the retirement date (including interest paid on such date) as the present value of the bond on such date (the "Approximate Method"). For this purpose, the term "eligible bond" is any bond issued at par plus accrued interest which pays interest currently at periodic intervals of one year or less, with a lowest stated retirement price not less than the outstanding par amount of the bond plus accrued interest and with respect to which no payment for a qualified guarantee is taken into account. Rebate Regulations Section 1.148-3T(b)(8)(iii). Accordingly, the issuer will generally be required to compute the bond yield using the Exact Method rather than the Approximate Method for bonds issued at a discount or premium from par and for bonds issued with a qualified guarantee.

Comments:

As stated above, the Committee believes that re-computation of yield should not be required. If this requirement is not deleted in the final regulations, the Committee has the following suggestions. In the case of bonds issued with a relatively small amount of discount or premium, the requirement that yield be recomputed based on the early retirement value causes additional complexity which appears to be significantly disproportionate to the additional rebate to be imposed due to the application of these rules. The examples contained in Exhibit 1 illustrate this point. For these reasons, the Committee suggests that the definition of "eligible bond" be expanded to include bonds issued with a de minimis amount of discount or premium (e.g., equal to or less than the greater of (i) two percent, or (ii) the number of years to maturity multiplied by one-quarter of one percentage point).

7. Special Rule for Fixed Rate Small Issues.

The Rebate Regulations provide a simplified yield rule for fixed yield issues (i) of bonds, including an issue of tax-exempt private activity bonds, with an aggregate issue price of $5 million or less and (ii) of bonds, other than private activity bonds ("governmental bonds"), with an aggregate issue price of $10 million or less, provided that the aggregate issue price of all governmental bonds issued by the issuer during the calendar year of the bond issue under consideration and during the immediately preceding calendar year does not exceed $30 million. ((i) and (ii) above, are hereinafter referred to as "Eligible Small Issues"). Unless an issuer otherwise elects, the yield on an Eligible Small Issue is computed once as of the issue date and is not computed thereafter.

In order to constitute an Eligible Small Issue, (1) all of the bonds must bear a fixed yield and must not have been converted from a variable yield, (2) the proceeds of the issue cannot be used to advance refund another issue or be otherwise subject to investment at a restricted yield under Treasury Regulations Section 1.103-13, (3) at least 75 percent of the net sale proceeds are allocated to expenditures (other than expenditures for debt service on the bonds) no later than the date that is three years after the date of the issue (and no later than the final computation date), and (4) no hedging transaction is entered into with respect to the issue which would increase the rebatable arbitrage when taken into consideration in computing the bond yield.

Comments:

The definition of “Eligible Small Issue” should be modified to significantly increase the aggregate issue price limitation to $30,000,000 regardless of whether H.R. 3299 or similar legislation is enacted into law.

8. Variable Yield Issues.

Rebate Regulations Section 1.148-3T(b) divides the term of variable yield issues into discrete “yield periods” and requires that the issue yield be computed separately for each period, taking into account only the payments on the issue made or deemed made during such period. This rule, in effect, treats a variable yield issue as a series of separate issues, with the term of each issue in the series equal to one yield period for the purpose of determining the amount (but not the time of payment) of rebatable arbitrage. The yield of each “issue” in the series is determined independently of the yield of prior or subsequent “issues” in the series and such yield is compared to the investment earnings attributable to the yield period of the “issue” to determine the amount of rebatable arbitrage for that period.

Rebate Regulations Section 1.148-3T(b)(2)(ii) provides that the first yield period for a variable yield issue begins on the date of issue and ends on the close of business on the first computation date (for a long-term bond issue, ordinarily five years from the date of issue). Each succeeding yield period begins immediately after the close of business on a computation date and ends at the close of business on the next succeeding computation date.

The issuer is entitled to elect to treat the last day of any bond year of a variable yield issue that is not a computation date as a computation date for purposes of determining the yield periods referred to above. Rebate Regulations Section 1.148-3T(b)(2)(ii)(B). An authorized representative of the issuer may revoke such election in writing at any time before the close of business on a computation date that precedes the last day of a bond year.

Within each yield period, the yield on a variable yield issue does not change once it has been determined. The yield on a variable yield issue during any yield period is the discount rate that produces the present value of all of the (i) issue payments with respect to the bonds during the yield period and (ii) issue prices of the bonds during the yield period. Rebate Regulations Section 1.148-3T(d)(1). All of these issue payments and issue prices are “present valued” as of the first day of the yield period using the same present value formula discussed in Section 5. of this Part, above.

The issue payments required to be taken into consideration during a variable yield period are (i) any interest and qualified guarantee payments, (ii) the Retirement Price for bonds retired within the yield period on their final maturity date, (iii) the Early Retirement Value for bonds to be retired within the period prior to their final maturity date and (iv) for bonds outstanding at the close of business on the last day of the yield period or for bonds converted from a variable yield to a fixed yield at the election of the issuer, an amount equal to (I) the Early Retirement Value of the bond at such time and (II) any unpaid accrued interest at such time that accrued on the bond during the yield period. Rebate Regulations Section 1.148-3T(d)(2)(i)(F). In determining the issue price for a bond to which (iv), above, applies, the bond is treated as if issued immediately after the close of business on the last day of the yield period or on the date the variable yield bond is converted to a fixed yield bond, as applicable, for an issue price equal to the Early Retirement Value of the bonds on that day. Rebate Regulations Section 1.148-3T(d)(2)(ii)(B).

For tender bonds, the issuer payments taken into account during a yield period include (i) interest and qualified guarantee payments and (ii) if the bonds are purchased pursuant to a tender right during the yield period, the amount paid to purchase the bonds (the “tender price”). If (ii) above applies, in determining issue prices during the yield period, the bonds are treated as if issued immediately after the close of business on the day the bonds are remarketed for an issue price determined in accordance with the rules discussed in Section 3. of this Part, above. Rebate Regulations Sections 1.148-3T(d)(2)(i)(C) and (ii)(A).

Comments:

The requirement that the yield on a variable yield issue must be calculated separately for each yield period should be made optional, at the election of the issuer. The segmentation of a single issue into a series of sequential issues represents a major departure from the general principles of tax-exempt finance as reflected, for instance in Advance Notice 88-130, 1988-2 C.B. 543, and such a departure should be limited to instances in which strong policy reasons mandate such special treatment. The justification offered by the Preamble for prohibiting issuers from computing the yield on a variable yield issue over the entire term of the issue does not support mandatory application of the segmentation rule. No specific issuer abuses are identified and, in their absence, only elective segmentation is warranted.

The Preamble states that special rules for the calculation of the yield on variable rate issues were necessary in order to “properly match” the return on investments with the cost of funds, so as to minimize “distortions” that would otherwise result from changes in market interest rates over the term of an issue. However, the apparent simplicity of this concept of proper matching dissolves upon close analysis, and the “distortions” identified in the Preamble either are distortions that unfairly penalize issuers (and thus can be remedied by an election) or are not really distortions at all.

The theoretical appeal of “proper matching” of the rates on bonds and investment of proceeds does not, on closer analysis, provide a reason for a separate rule on variable rate issues. In a typical new money deal, bond proceeds to be used for project acquisition and construction will be invested short, regardless of whether the bond issue itself is a fixed rate issue or a variable yield issue. Similarly, reserve funds for both fixed rate issues and those variable yield issues that have reserve funds are typically invested medium to long. In both cases, the term of the investments chosen is dictated by considerations other than the yield on the bond issue, i.e., by the use to which such investments are intended to be put. Thus, the assumption, implicit in the norm of “proper matching,” that the return on the investment of proceeds of a variable yield issue will vary in tandem with the yield on the issue itself is not mandated in theory and unlikely in actual practice.

With respect to “distortions,” the Preamble offers two examples of that Treasury believes warrant special treatment of variable yield issues. First, where interest rates decline after an issuer has spent all of the bond proceeds on construction, the issuer would, in the absence of a special rule, incur an additional rebate obligation at a time when it may have no additional funds with which to satisfy such obligation. The Preamble at page 38 states that “the issuer should not have to rebate more since the arbitrage profits do not in fact change.” This statement begs the question, because if one views a single issue as having a single yield, as Section 148(f)(2)(A)(ii) of the Code strongly suggests one should, then the arbitrage profits do in fact change as a result of the subsequent change in market rates: it is the investment earnings, and only the investment earnings, that remain the same.

While granting special treatment in this instance, the Preamble avoids an explicit statement of the justification for such treatment. However, it implies that the imposition of such an obligation would be unfair, because the “arbitrage profits do not in fact change.” The proper focus for the evaluation, however, should be the professed Congressional purpose for imposing the rebate requirement: to eliminate premature and excessive bond issuance and the extension of bond maturities for the substantial purpose of earning arbitrage profits. It is doubtful that any issuer would issue bonds for the prohibited purpose of producing arbitrage profits that might materialize only as a result of an unforeseeable decline in market rates subsequent to the end of the construction period. Any economic benefit that results, though unexpected, nevertheless remains arbitrage earnings. The proper justification for the exception is that they are the kind of arbitrage earnings that it is reasonable to permit issuers to keep because requiring rebate for such unexpected arbitrage earnings would not further the objectives of Congress.

The lack of a coherent justification for what is surely the correct rule in this situation reflects what we believe is a fundamental problem with the approach taken in the regulations. Both the Preamble and the Rebate Regulations themselves move away from the express intent of Congress described above, and substitute the far more aggressive goal of extracting all arbitrage profits, wherever they may be found and however insignificant they may be. The Rebate Regulations make an exception here, but it is important to remember that it is arbitrage profit that such issuers are being permitted to keep. The acknowledgment (properly) of the exception and the weakness in the rationale advanced argue against the theoretical soundness of the basic approach of the regulations.

While the special treatment described above would seem to be justified, the special treatment required in the second example cited by the Preamble is not justified by any “distortion” resulting from changes in market interest rates. This second example focuses upon tender bonds that “bear interest at short-term rates during construction (when the proceeds are invested) and thereafter convert to a long-term fixed interest rate.” In this instance, it is obvious that treating such a tender bond issue according to the principles used to treat fixed yield issues could significantly reduce the issuer's rebate obligation. But, again, this reduction should be viewed as unwarranted only if there are good reasons for making an exception to the normal principles that a single issue of bonds has a single yield over its entire term.

Rather than offering such a justification, the Preamble simply asserts that there is a “distortion” involved and that fixed rate bonds and tender bonds are fundamentally different. As the Preamble states at page 39, “... the conversion of a tender bond to a long-term fixed rate bond resembles the refunding of a short-term bond with a long-term bond” and “[a] refunding issue is a separate issue and involves a separate yield and rebatable arbitrage computation.” This observation, once again, begs the question, because, although the conversion of a tender bond in certain respects resembles a current refunding, the IRS, in the reissuance analysis contained in Notice 88-130, supra, and elsewhere, expressly differentiates the conversion of certain tender bonds from current refundings. The special treatment required of tender bonds in this instance is justified only if there are good reasons to treat as a series of distinct refundings what, under ordinary principles of the law governing tax-exempt finance, would be treated as a single issue of bonds. The Preamble offers no such argument justifying special treatment in this instance and such special treatment should not be compelled.*

The most efficient means of addressing the variety of concerns described here is to make multiple yield calculations of variable yield issues optional, at the election of the issuer. No abuses have been identified that would justify compelling issuers to compute the yield on variable yield issues by either of the available mechanisms, while, on the other hand, forcing issuers to rebate contingent arbitrage could impose severe practical difficulties of compliance without in any way furthering the professed intent of Congress. Thus, no harm, and much good will result from permitting issuer discretion.

Finally, it is not clear whether the Treasury intended by the mandatory special treatment of variable yield issues to target certain perceived abusive financing practices, but if it believes such practices exist in this area, it should identify them and tailor the special treatment to each such instance.

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* The effect of the rule is to prevent the use of "target rate" bonds in advance refundings. If the Treasury Department objects to such use, it has other tools to deal with advance refundings. See Section 149(d)(4) of the Code.

9. Qualified Guarantees.

(a) The “Guarantee” Element.

The payments for a qualified guarantee are added to other payments on a bond to determine the yield of the bond. The Rebate Regulations, generally, define a “guarantee” with respect to a bond as an unconditional and recourse obligation of a guarantor (enforceable by or on behalf of the holder of the bond) to pay all or any part of any payment of principal or interest on the bond or tender price of a tender bond that is actually and unconditionally due under the terms of bond. Guarantees may be in the form of an insurance policy, surety bond, irrevocable letter or line of credit or a standby purchase agreement. The regulations provide that a recourse loan to a guarantor, the terms of which are substantially identical to the terms of the corresponding bonds, may be a guarantee if the loan is “in substance” a guarantee. Rebate Regulations Sections 1.148-3T(b)(12)(ii)(A) and (E).

The Rebate Regulations also permit a guarantee of principal and interest on certain acquired purpose investments (e.g., a multi- family housing loan agreement) to be treated as a guarantee of the related principal and interest payments on the bonds. The payments on the acquired purpose investment must coincide with such payments on the bonds and must be pledged exclusively to the debt service payments on the bonds, or in certain cases, to the debt service of parity issues. The acquired purpose investment may not be a student loan or single family mortgage loan. The acquired purpose investment must be acquired with the sale proceeds of the bonds and the yield on the acquired purpose investment may not exceed the yield on the bonds by more than one-eighth of one percentage point. For purpose investments acquired on or before June 14, 1989, the investments may be modified to comply with this one-eighth of one percentage point yield limit (rather than the alternative one and one-half point spread allowed for acquired program investments). Rebate Regulations Sections 1.148-3T(b)(12)(v),(vi) and (viii).

In order for a guarantee to be a “qualified” guarantee, for purposes of treating the fees paid in connection therewith as non-purpose payments in computing the bond yield, there are three basic requirements:

> (1) The guarantor's obligation to pay must be in the nature of a “secondary liability,” i.e., it must be reasonably expected that the guarantor will not be called upon to make any payments under the guarantee, and if and when payments are made, the guarantor must be entitled to full reimbursement immediately or upon commercially reasonable repayment terms (e.g., a standard reimbursement agreement);
>
> (2) The guarantor's obligation to pay must shift the ultimate credit risk with respect to the bond issue (which disqualifies a guarantee by an entity or related person to the extent such guarantor entity or related person is otherwise obligated to pay debt service on the bonds, as would be the case with the ultimate obligor of a private activity bond); and
>
> (3) The guarantee fees must not exceed a reasonable charge for the transfer of credit risk in relation to fees charged in comparable transactions, and the present value of the fees (using the yield-to-maturity as the discount rate) must be less than the present value of the interest saved as a result of the guarantee. Rebate Regulations Section 1.148-3T(b)(12)(ii)(B) and (D) and (iii).

Comments:

The Committee requests clarification that a "guarantee" is qualified in the event that it is conditional or revocable under circumstances where there is also an irrevocable, unconditional guarantee provided by the same or another guarantor with respect to the same bond issue. An example would be a liquidity standby purchase agreement subject to an event of default where there is a separate letter of credit covering the default risk. The liquidity feature represents a distinct element of credit risk that may be borne by the same institution or a separate institution that guarantees the default risk. The Committee believes the liquidity feature should be separately recoverable provided the fee received is arms length.

The Committee supports the position in the Rebate Regulations that a guarantee of the principal and interest on an eligible purpose investment is in substance a guarantee of the debt service on the related bonds. Rebate Regulations Section 1.148-3T(b)(12)(v). However, the Committee has two concerns about the requirements that must be met in order to recover guarantee fees in this context. First, the "payments coincide" rules set forth in Rebate Regulations Section 1.148-3T(b)(12)(vi) are unnecessarily complex, even after the amendments of Advance Notice 89-78 are taken into account. As long as the payments of principal and interest on the acquired purpose investment (and all related payments under the guarantee) are at all times pledged exclusively to the debt service on the bonds, the exact timing should not matter.

Second, the Committee also questions the rationale for limiting qualified guarantees of acquired purpose investments to only those with respect to which the issuer has elected to recover its costs plus 1/8 of one percentage point spread over the bond yield. As discussed above under Section 1. of Part II, the 1986 Act legislative history does not indicate an intention to repeal the issuer election to pay program costs out of a 150 basis point spread over the bond yield. Partly because many transactions have been consummated on this premise, and partly because the Rebate Regulations, as amended by Advance Notice 89-78, indicate an intention to permit the recovery of guarantee fees in respect of acquired program investments (which the Rebate Regulations in their present form would render superfluous), the Committee recommends that the qualified status of guarantees in respect of all acquired purpose investments not be limited by the issuer's election to recover costs (plus 1/8 of one percentage point) or pay them out of the 150 basis point spread.

(b) Creditworthiness.

The Rebate Regulations also require that the "guarantor" meet certain minimum standards for creditworthiness. The guarantor must be (i) an entity that is not exempt from federal income taxation and is either a bank or has a long-term debt rating in either of the two highest rating categories ("AA" or "AAA") by a nationally recognized rating agency, (ii) a state insurance fund established before May 15, 1989, but only with respect to guarantees of obligations of persons other than State and local governmental units and of the type guaranteed by such fund before May 15, 1989, and (iii) the United States or any agency or instrumentality thereof. Rebate Regulations Section 1.148-3T(b)(12)(ii)(C). Advance Notice 89-78 amends (i) above to include non-exempt entities rated “Aa” or “Aaa,” as well as “AA” and “AAA,” with respect to unsecured (as opposed to long-term) debt or insurance underwriting or claims paying ability. The Notice also adds non-exempt entities that cause obligations insured by their insurance policies to be rated in one of the two highest rating categories.

Comments:

The Committee does not believe there is any rationale for requiring insurance companies, but not banks, to be rated in one of the two highest rating categories in order to constitute a “qualified guarantor.” It is important to note that unrated insurance companies were not excluded under prior regulations governing cost recovery. Treas. Regs. Section 1.103-13(c)(8). Accordingly, the Committee recommends that the rating requirement be deleted in the final regulations.

(c) The “Non-guarantee” Element.

As in the Conference Report Explanation of the 1986 Act, the Rebate Regulations require that the “non-guarantee” element of any guarantee fee (e.g., remarketing fees) be excluded for purposes of determining non-purpose payments with respect to a bond issue. For guarantees entered into after June 14, 1989, the Rebate Regulations require that the fees for any non-guarantee services be separately stated. In general, a non-guarantee payment is a payment for a cost or risk not “customarily borne” by guarantors of tax-exempt bonds. Rebate Regulations Section 1.148-3T(b)(12)(iv)(A).

The Rebate Regulations contain several examples of “uncustomary” items that are considered “non-guarantee” elements of a fee: (1) fees that are refundable if the bonds are retired early and the amount of the refund exceeds the unearned portion of the guarantee payments; (2) fees received by a guarantor where the guarantor is not reasonably assured that sufficient funds will be available to fully retire the bonds {after netting the amounts rebatable) in the event that none or an insubstantial amount of the proceeds are expended for a governmental purpose (i.e., collapsible escrow bonds); (3) guarantee payments with respect to a revenue bond where the guarantee is used to replace hazard insurance; (4) in the case of a guarantee in the form of a loan to the guarantor, guarantee fees that are more than those customarily charged by other guarantors or non-guarantee fees less than those customarily charged and (5) if the issuer or ultimate obligor of a tender bond is not required to use best efforts to remarket tender bonds, payments guaranteeing the tender price of such bonds. Rebate Regulations Section 1.148-3T(b)(12)(iv)(C).

Comments:

The “customarily borne” standard, while conceptually helpful in appearing to permit the continuance of ordinary course practices, is a difficult standard to actually apply because it is subject to a variety of reasonable interpretations. Such an open- ended standard should not be coupled with such a harsh sanction as disregarding the entire guarantee fee for yield calculation purposes in the event of an incorrect application of the standard or an innocent mistake in its application, however de minimis. The Committee recommends that the final regulations provide more guidance in the form of examples of some of the types of payments that will be treated as costs customarily borne by guarantors. One example would be legal and rating agency fees incurred by a guarantor. In addition, the final Rebate Regulations should scale the penalty to the breach by disqualifying only that proportionate amount of a cost that is treated as not “customarily borne” by a guarantor.

As noted above, the Rebate Regulations also provide (through an example) that a guarantor will be treated as having assumed a “non-customary risk” (thus causing its guarantee not to be a “qualified guarantee”) if such guarantor “is not reasonably assured that sufficient funds will be available to fully retire the bonds . . . in the event that none (or an insubstantial portion) of the proceeds of the issue is expended for a governmental purpose . . . .” Rebate Regulations Section 1.148-3T(b)(12)(iv)(C), Ex. 2 (emphasis added). The Committee recommends two changes to this example. First, the example should clarify that the only time to test a guarantor's reasonable assurances is at the point such guarantor enters into a binding commitment to provide its guarantee. Second, the “insubstantial portion” parenthetical should be deleted because it is unlikely that a guarantor will be reasonably assured that yield restricted proceeds[*] could accrete to a level sufficient to fully retire the bonds after even an “insubstantial portion” of such proceeds had been expended for governmental purpose.

(d) Level Versus Non-level Payments.

The Rebate Regulations provide several allocation rules for allocation of payments with respect to qualified guarantees. First, the regulations separate these payments into two categories, level payments and non-level payments. The term “level payment” is defined as a payment that is one of a series of payments (i) due at periodic intervals at least once within each bond year while the guarantee of the bond is in effect, (ii) that is the same percentage of the outstanding amount of the bond plus accrued interest for a period of no longer than one year and (iii) due no earlier than one year before and no later than one year after the date the payment is calculated. All other

[*] Even if such proceeds were not yield-restricted, any arbitrage would most likely be rebatable arbitrage unavailable for the payment of debt service.

guarantee payments are treated as “non-level” payments. Rebate Regulations Section 1.148-3T(b)(13)(iii)(B). In the case of level payments for a guarantee, the level payments are ordinarily treated as “paid” when actually paid on the due date regardless of whether the bonds are fixed yield or variable yield bonds. Rebate Regulations Section 1.148-3T(b)(13)(ii)(A). However, for variable yield bonds retired before the final maturity date, payments for a guarantee that are allocated to the period after the retirement date (under the allocation rules discussed below) are not counted. Rebate Regulations Section 1.148-3T(b)(13)(ii)(C).

For both fixed yield and variable yield bonds, non-level guarantee payments are required to be allocated in a manner that reflects the proportionate interest reduction resulting from the guarantee (determined on a present value basis) between and among bonds that are not identical (e.g.. serial bonds and term bonds). With respect to bonds that are not readily marketable without a guarantee, such as industrial development bonds issued for the benefit of a small company, the proportionate credit risk is to be measured by use of any “reasonable method” that properly reflects the proportionate credit risk for which the guarantor is compensated. Rebate Regulations Section 1.148-3T(b)(13)(i)(A).

For variable yield issues, non-level guarantee payments are required to be further reallocated, or spread, throughout the term of the guarantee. For example, a simple lump-sum premium paid to insure a variable yield issue would constitute a non-level payment required to be reallocated and treated as paid throughout the term of the bonds. Such payments are treated as paid on the first day of each bond year, with the first bond year deemed to begin the first day the guarantee is in effect and the last bond year deemed to end on the date the guarantee is no longer in effect, disregarding any early redemptions of bonds. Each deemed payment is an amount equal to the present value of all non-level payments allocated to each bond, divided by the present value of the sum of one dollar for each year the guarantee is in effect without regard to any early retirement prior to final maturity of such bond. This present value is computed as of the first day the guarantee is in effect using as the discount rate the composite yield on all variable yield bonds to which the non-level payments relate (taking into account only guarantee payments which are level payments) throughout the first yield period during which the guarantee is in effect at least one year, or, until the guarantee terminates within such yield period. Rebate Regulations Section 1.148-3T(b)(13)(iii)(C). The resulting periodic payment is referred to as the "constant payment amount."

Comments:

The Committee objects to the rule requiring non-level payments for a guarantee to be allocated between and among non-identical bonds by reference to the proportionate interest reduction resulting from the guarantee. Rigid adherence to such a vague rule is an invitation to disputes in practice that will pose problems unnecessarily for both taxpayers and the IRS. The proportionate credit risk between and among bonds that are not identical should be allocable on the basis of any reasonable method that properly reflects such risk, regardless of whether the bonds are readily marketable with or without a guarantee. See

Rebate Regulations Section 1.148-3T(b)(13)(i)(B). Typically, bond insurance fees are a percentage of total covered debt service. The Rebate Regulations should permit non-level payments to be allocated in the same way.

The Committee requests that the rule requiring reallocation of payments throughout the term of the guarantee, particularly the rule requiring computation of the “constant payment amount,” be deleted in the final regulations. This rule does not reflect the economic cost of the guarantee fee to the issuer. If the guarantee fee is not rebated or refunded in part to an issuer where the variable yield bonds are retired early, this rule assumes the fees are not paid at all.

The effect of the aforementioned reallocation rule is to reduce the amount of the lump-sum premium for a qualified guarantee that is taken into account in computing the bond yield because (i) premiums paid at closing, or shortly thereafter, are treated as paid over several years (reducing their positive impact on the bond yield on a present value basis), and (ii) reallocated payments deemed to occur after the early retirement of a bond are simply not counted at all. (Note in this regard that if the need to recalculate yield by means of the early retirement value is deleted, as suggested above, then the need to allocate non-level payments and the complexity of doing so will also be eliminated in fixed yield issues.) Similar adjustments should be made in the variable yield issue calculations in the event of early retirement, although not if multiple calculation periods are elected.

The “nonguarantee” element of a guarantee payment includes amounts to which an issuer is entitled as a refund in the event the obligation is retired prior to final maturity. See Rebate Regulations section 1.148-3T(b)(12)(iv)(c), Ex. (3). with respect to certificates of participation (“COPs”), subject to annual appropriation by the underlying obligor, the guarantee may terminate (as will the obligation to pay under the COPs themselves) upon an event of non-appropriation. Thus, in this case, the obligor under the COPs will be entitled to a reimbursement of some portion of the guarantee fee upon an event of non-appropriation. The final regulations should specify that guarantee fees relating to COPs are fully recoverable in this situation, subject only to any refunds actually received by the obligor due to non-appropriation in excess of the amount of such fees actually earned.

10. Yield-to-Call Bonds.

The Rebate Regulations provide a special set of rules designed to increase the rebatable arbitrage for bonds sold at a significant premium that are callable at par after a few years. These special rules apply to a “yield-to-call bond,” defined as: (1) any bond that is part of a fixed yield issue if the yield-to-maturity on the bond is more than one-quarter of one percent (one-sixteenth of one percent in the case of fixed yield issues with an issue price of $35 million or more) higher than the lowest yield-to-call; (2) any fixed yield bond or current index bond that is part of a variable yield issue if the yield-to-maturity on the bond is more than one-sixteenth of one percent higher than the lowest yield-to-call; and (3) any variable yield bond (other than a current index bond) that is part of a variable yield issue if the yield-to-maturity on the bond is higher than the lowest yield-to-call. Rebate Regulations Section 1.148-3T(b)(4)(ii). Tender bonds are excluded from the yield-to-call bond category.

The yield on a yield-to-call bond is not determined throughout its entire term. Such bond is treated as if the lowest yield-to-call date is the final maturity date and the stated retirement price on that date is the Retirement Price. Rebate Regulations Section 1.148-3T(b)(4)(i). The “lowest yield date” is the date that when used in computing the yield on the bond produces the lowest yield. Advance Notice 89-78 clarifies the definition of “lowest yield” by providing that for purposes of computing the lowest yield, the stated retirement price on the lowest yield date is treated as an unconditionally payable payment of principal and interest on the bonds. This date will ordinarily be the first optional call date.

If a yield-to-call bond is not in fact retired on or before the lowest yield-to-call date, the bond is treated as if it were (i) retired on such date for the stated retirement price and (ii) reissued on such date (as part of the same issue) for an issue price equal to the stated retirement price (less any amounts used on such date to actually redeem bonds or to pay interest).

For purposes of determining whether a variable yield bond is a yield-to-call bond and for purposes of computing the yield on, the present value of, and Early Retirement Value of the bond:

> (1) any interest that is unconditionally payable but that does not accrue at a rate that is fixed and determinable as of the date of issue is not taken into account;
>
> (2) the interest that is treated as unconditionally payable is the interest that is fixed and determinable on the date of issue on the basis of the rate established by the interest index or other rate-setting mechanism on such date (in effect, a constant market assumption);
>
> (3) qualified guarantee payments are ignored except that they are treated as level payments for purposes of a yield-to-call bond; and
>
> (4) interest that accrues on a bond on or before a date and that is payable on or after such date is not taken into account in determining the present value of a bond on such date. Rebate Regulations Section 1.148-3T(b)(9).

Comments:

The Committee urges the Treasury Department to adopt a *de minimis* rule which provides the yield-to-call rule will not apply to any bond sold at a premium equal to or less than the greater of (i) two percent, or (ii) the number of years to maturity multiplied by one-quarter of one percentage point.

The Committee believes that the term “lowest yield date” in Rebate Regulations Section 1.148-3T(b)(5)(iii) should be deleted, or if not deleted, should be further limited to principal or interest payment dates to avoid the requirement that yield be computed daily.

The Rebate Regulations also require that the date of any mandatory or optional call from any unexpended proceeds must also be taken into account. Computing the yield using the lowest yield-to- call rule will lower the bond yield and result in accelerating the rebatable arbitrage to the earlier calculation dates -- but, if the bond is not retired early, will not increase the rebatable arbitrage of a fixed yield issue (except to the extent the rebate is not refundable). This rule precludes the structuring of bond issues with high interest rate coupons to be sold at a premium in order to increase the bond yield (thereby reducing the rebatable arbitrage), where the bonds are optionally redeemable after a few years without a significant call premium. Any issuer may inadvertently create a yield-to-call bond, however, in the event there are excess proceeds in a construction fund after a project is complete and the documents require that the issuer use these excess proceeds to call bonds on the first optional call date as required by Rev. Proc. 79-5, 1979-2 C.B. 485, or on some other date.

As noted above, the rules relating to yield-to-call bonds apply to bonds issued at a premium (and callable at par) and to bonds which bear a low coupon for a period of time and automatically convert to a higher rate at a predetermined time. The final regulations should identify these types of bonds as the only types of bonds that can be yield-to-call bonds. This will eliminate any reason to be concerned about yield-to-call rules in the vast majority of transactions.

An additional simplification would be to defer the determination of whether a bond is a yield-to-call bond until the first computation date after the call date. If at such time bonds have been retired, yield-to-call status will be triggered. If bonds have not been retired, it should not be necessary to treat the bond as reissued. The only effect of this would be to avoid an acceleration of rebate to the federal government, a benefit that will only produce de minimis economic benefit to the Treasury and which does not justify the complexity involved.

As noted above, private activity bonds containing so-called calamity calls in order to comply with Rev. Proc. 79-5 (and other bonds with similar provisions) with even a slight premium may be characterized as yield-to-call bonds due to the proximity of the calamity call date to the date of issue. This will also result in the early retirement value being based on the “lowest yield.” Accordingly, the Committee recommends that, in the case of bonds issued at a premium, the yield-to-call and lowest yield rules only apply where the premium exceeds some de minimis amount.

As a technical matter, there does not appear to be a parallel yield-to-call rule for purpose investments leading to the possibility of the purpose investment yield (without yield-to-call rules) being materially higher than the bond yield (with yield-to-call rules).

11. Yield-To-Call Bonds - Special Considerations for Variable Yield Issues.

As long as the Rebate Regulations continue to require that the yield on variable rate issues be computed separately for each yield period, the definition of a yield-to-call bond should be changed to provide that no variable yield issue may be considered a yield-to-call bond. The Preamble indicates that the principal justification for the mechanism used to calculate the yield on variable rate issues is the desire to match the current cost of borrowing with the current return on investment. However, the mechanism employed in Rebate Regulations Section 1.148-3T(b)(9) for determining whether a variable yield bond (other than a tender bond) is a yield-to-call bond requires the contrary-to-fact assumption that the initial rate of interest on the variable yield bond will remain the rate of interest to be paid on such bond throughout its entire term. Neither the Rebate Regulations themselves nor the Preamble offer any justification for ignoring what the Preamble and Rebate Regulations identify as the fundamental goal of that part of the Rebate Regulations that deals with variable yield issues.

In the alternative, if the regulations are not revised to provide that no variable yield bond may be a yield-to-call bond, the provisions of the regulations that narrow the permissible yield spread for variable yield bonds from the 25 basis points permitted bonds that are part of a fixed yield issue should be eliminated. No justification for such special treatment is identified in either the Preamble or the regulations. If certain specific abuses are being targeted, they should be identified and the special treatment targeted toward their elimination.

12. Discount Bonds Subject to Mandatory Early Redemption.

When bonds subject to mandatory early redemption are issued at a significant discount, the Rebate Regulations require the issuer to compute the yield on the issue as if the bonds subject to mandatory early redemption are redeemed at the accreted value (*i.e.*, below par) on the mandatory redemption dates (referred to as the lower market price) rather than at par. This special rule is applied only if the yield-to-maturity on the bond subject to mandatory early redemption is more than one-quarter of one percentage point lower than the composite yield to maturity on all bonds of the issue subject to the same mandatory sinking fund redemption schedule. Rebate Regulations Section 1.148-3T(b)(7)(iii).

Comments:

Generally, the Committee believes that the special rule for discount bonds subject to mandatory early redemption is an improvement over the methodology provided by prior IRS authority on this subject (Rev. Rul. 79-344, 1979-2 C.B. 42). However, the Committee urges the Treasury Department to adopt a *de minimis* rule pursuant to which this special rule for discount bonds would not apply to any bond sold at a discount equal to or less than the greater of (i) two percent, or (ii) the number of years to maturity multiplied by one-quarter of one percentage point.

PART IV. REBATE PAYMENTS AND PENALTIES

1. 90% Rule for Installment Payments.

Code Section 148(f)(3) provides that at least once every five years during the term of the issue, installments are due in amounts that, together with prior installment amounts, equal at least 90% of the rebate liability determined from the date of issue of the bonds through the installment date. Code Section 148(f)(3) authorizes the Secretary to alter the installment payment date rule and perhaps the installment payment amount rule.

The Rebate Regulations provide that at least 90% of the "rebatable arbitrage" computed as of the end of the fifth bond year and each succeeding fifth bond year must be paid no later than 60 days after the respective computation dates. Rebate Regulations Section 1.148-1T(b). "Rebatable arbitrage" as of any computation date means the unpaid portion of the rebate liability computed through such installment date. Rebate Regulations Section 1.148-2T(a).

Comments:

The Rebate Regulations depart from the Code rule that cumulative rebate installments (including the current installment) equal 90% of the rebate liability as of the current installment date. Instead, the Rebate Regulations require an installment payment equal to 90% of the unpaid rebate liability computed as of such installment date. The effect is that the 10% rebate holdback allowed an issuer on an installment date must substantially be paid on the next installment payment date, rather than at the date for final rebate payment which occurs 60 days after retirement of the issue.

The faster payment of the holdback allowance makes the Rebate Regulations less, not more, workable in terms of capturing arbitrage profits, and is therefore contrary to Congress' intent. The 10% holdback protects an issuer from paying rebate installments which, in the hindsight of subsequent computation periods, prove to be payments (in whole or part) of borrowed capital rather than of arbitrage profits. Faster holdback payments strip away much of this protection. No substitute in the form of a right to recover overpayments of rebate is provided, nor will it be, since the Preamble states that, in general, such recoveries will be barred. The Rebate Regulations offer no justification for departing from the formula provided by the Code for installment payments. The rebate regulations under prior law did not change the installment payment rule of the 1954 Code, which is identical to the corresponding rule of the Code. Instead, the prior regulations used the 1954 Code rule to mitigate the prior regulations' bar to recovery of rebate overpayments. This approach should be continued under the Code if recoveries of overpayments are to be generally prohibited. We therefore believe that the Rebate Regulations should adhere to the Code rule that cumulative rebate installment payments equal 90% of rebate liability as of the current installment date.

2. Final Rebate Payment for Certain Short-Term Issues.

Under Code Section 148(f)(3), the final rebate payment is due 60 days after the last bond of the issue is redeemed. For tax and revenue anticipation notes (“TRANS”), the final rebate payment is not due until the later of 60 days after the retirement date of the TRANs and eight months after the date of issuance thereof. The Rebate Regulations provide that the final payment of rebatable arbitrage and any “income attributable to rebatable arbitrage” is due on the later of (i) 60 days after the last bond of the issue is discharged, (ii) the date eight months after the date of issue of the bonds, or (iii) the date 60 days after the earlier of the date the issuer no longer reasonably expects Code Section 148(f)(4)(B) (the temporary period expenditure exception from rebate) to apply to the issue and the date 12 months after the date of issue of the bonds. Rebate Regulations Section 1.148-1T(b)(3)(ii); Advance Notice 89-78.

Comments:

The Committee recommends deletion of the special final payment date rule requiring rebate to be paid on the later of 60 days after the earlier of the date the issuer no longer reasonably expects Code Section 148(f)(4)(B) to apply or the date 12 months after the date of issue. If not deleted in its entirety in the final Rebate Regulations, this rule should be replaced with a straightforward mechanical method of determining the final payment date.

The special final payment date rule is intended primarily to assist non-private activity bond issuers and qualified 501(c)(3) bond issuers whose TRANS have been retired for more than 60 days without a final rebate payment because there remain proceeds which are expected to be expended within the one-year period required for such issuers to qualify for the exception from the Rebate Requirement. The “reasonable expectations” of the issuer in this regard after the date of issue are difficult to determine and make this rule impossible to administer. Issuers utilizing the rule will make “final” rebate payments with the knowledge that years later their determination of the final payment date may be challenged and ah additional rebate liability assessed. This does not appear consistent with the Rebate Regulations' purpose to reduce administrative complexity.

In the situations to which it applies, the rule at most will serve to accelerate the final rebate payment date from 14 months after the date of issue (the latest date permitted under the rule) to 8 months after the date of issue (the earliest date on which a final rebate payment is due in any event). The Treasury would seem to be adequately recompensed for a six month delay in receiving the final payment by the rule in the Rebate Regulations which imputes income attributable to rebatable arbitrage during the period from the final bond redemption date to 15 days before the final payment date.

Accordingly, the Committee recommends that the special final payment date rule for TRANS no longer expected to qualify for the temporary period expenditure exception be deleted or replaced with a rule that the final payment date be 14 months after the date of issue in such situations. If the special final payment date rule is retained in its present form, the Committee suggests that an issuer be permitted to establish the final payment date by certifying as to its reasonable expectations as of the date of issue, as is currently permitted, to establish compliance with the general rules of Code Section 148(a).

3. De Minimis Exception for Income Attributable to Rebatable Arbitrage.

The Rebate Regulations require the final rebate payment to equal the sum of the rebatable arbitrage as of the final computation date and any “income attributable to rebatable arbitrage.” Income attributable to rebatable arbitrage is the amount actually earned (or deemed earned in certain circumstances) on the final installment of rebatable arbitrage from the date the last bond of the issue is discharged through the date 15 days before the final installment is due. Rebate Regulations Section 1.148-1T(b)(2). However, no income attributable to rebatable arbitrage need be paid if the amount of such income is less than $300 and the final rebate installment is timely paid. Rebate Regulations Section 1.148-1T(b)(2)(iv).

Comments:

In the interest of administrative convenience, the Committee recommends that this rule requiring an additional rebate of amounts earned after the obligations are retired be deleted in the final regulations. The *de minimis* exception excusing payments of less than $300 of income attributable to rebatable arbitrage does not accomplish its purpose of reducing the administrative burden of the Rebate Regulations. Issuers will too often be required to compute income attributable to the arbitrage to determine whether they qualify for the rule. Alternatively, the Committee suggests that the *de minimis* rule be modified so that it applies whenever the rebatable arbitrage as of the final computation date is at least the lesser of $40,000 or 10 percent of the total amount of rebatable arbitrage over the entire term of the issue. The $40,000 figure is obtained from dividing $300 by the product of 45/360 and an assumed SLG rate of 6 percent.

4. Innocent Failure.

If bonds which are not private activity bonds, or if private activity bonds which are qualified 501(c)(3) bonds, violate the Rebate Requirement, Code Section 148(f)(7) allows the Secretary to impose a monetary penalty on the issuer in lieu of taxing interest on the bonds. The Secretary may waive all or part of the penalty. If the rebate failure is due to willful neglect, the monetary penalty alternative is not available.

Under the Rebate Regulations, the innocent failure to pay rebate amounts in respect of an issue will not result in either a penalty or the loss of tax-exemption of interest on the issue if the “correction amount” is paid, in general, no later than 60 days after the failure is discovered (180 days if the correction amount is less than $50,000). Rebate Regulations Section 1.148-1T(c)(1). The “correction amount” is the amount of rebate not paid when due plus interest at prescribed rates for the period from the due date through 7 days before payment of the correction amount. Rebate Regulations Section 1.148-1T(c)(2).

Factors to be taken into account in determining whether a failure to pay a required amount is innocent include the size of the correction amount, the size of the issue, the sophistication of the issuer (or ultimate obligor), the steps taken to comply and the nature of the length of the delay. Rebate Regulations Section 1.148-1T(c)(1)(ii)(A).

If the correction amount is $50,000 or more, the failure will in no event be considered innocent unless payment of the correction amount is accompanied by a brief explanation of the failure and the basis for concluding that it is innocent. Rebate Regulations Section 1.148-1T(c)(1)(ii)(B).

A correction amount is deemed innocent if (i) it is paid no later than 60 days after discovery of the failure (180 days if the correction amount is less than $50,000), (ii) the Commissioner does not notify the issuer to the contrary within 90 days after receipt of the correction amount and (iii) for correction amounts of $50,000 or more, the brief explanation required to accompany payment of the correction amount is reasonably accurate. Rebate Regulations Section 1.148-1T(c)(1)(ii)(C).

Comments:

The concept of “innocent failure” under the tax law is unique to the Rebate Regulations. While the Committee applauds the general approach of excusing certain issuers from penalties for noncompliance with the Rebate Requirement, unfortunately the Rebate Regulations articulate no general standard of “innocent failure.” A list of factors to be evaluated in determining the innocence of a failure is provided. But the Rebate Regulations do not relate the factors to a general rule and offer no guidance as to whether the list is exclusive or as to the relative importance of the factors. Issuers will have little understanding of “innocent failure” other than that it is a tool to be used by the Commissioner within limits that are not well delineated. Such a view detracts from the innocent failure rule's presumed purpose of comfort to issuers who in good faith seek to comply with the Rebate Regulations.

The Committee recommends that Rebate Regulations clarify the scope and meaning of “innocent failure” through a statement of general principles or by providing examples. Thus, the Rebate Regulations should make clear that the innocent failure rule is not limited to the concept of “innocent mistake” (inadvertent, insubstantial error, e.g., in arithmetic) found in other municipal regulations (Treas. Reg. Secs. 1.103-13(a)(3), -15AT(a)(2)). The Committee also believes that while timeliness of payment after the amount due is determined is a factor appropriately considered, the conclusion as to whether a failure to pay is “innocent” should not automatically be dependent -- favorably or unfavorably -- upon the timeliness of the payment after the failure to pay is discovered. Further, the final regulations should allow (i) a relief period of 180 days after discovery of the failure to pay regardless of the magnitude of the correction amount, and (ii) an extension of 60 days upon good cause shown where the taxpayer needs more time to evaluate the correction amount to be paid.

The relationship between the absence of willful neglect, as set forth in the rebate penalty provision of the Code and the Rebate Regulations, and innocent failure should also be addressed. The Rebate Regulations should further indicate whether innocent failure can be shown by reliance on the formal or informal advice of a qualified advisor, the informal advice of an IRS agent, or the activities of an agent retained to undertake rebate compliance. See Treas. Reg. Secs. 6a.103A-2(c)(1)(i), (ii) and (iv); 6a.103A-3(b) providing good faith compliance rules for qualified mortgage bonds and qualified veteran's mortgage bonds.

5. Penalty in the Nature of Interest.

The Rebate Regulations provide that the exclusion from gross income for interest on the bonds will be preserved in the case of a non-innocent failure to pay a required rebate amount if the Commissioner determines that the failure is not due to willful neglect and the correction amount is paid together with interest and a penalty. Rebate Regulations Section 1.148-1T(c)(3). Interest is computed on the amount of rebate not paid when required at the underpayment rate established under Code Section 6621 for the period beginning on the due date of amount required to be paid.

Comments:

The Committee believes that the Rebate Regulations impose an unwarranted double penalty on issuers whose rebate failure, while not innocent, is not due to willful neglect. To avoid loss of tax- exemption of bond interest, such issuers must pay a correction amount and a penalty which includes interest on the amount of rebate not paid when due from that date to the payment date at the underpayment rate established under Code Section 6621. Since the correction amount includes interest on the unpaid rebate amount at the prescribed correction rate, the issuer is in effect required to pay a double interest charge for a delay in the payment of required rebate. This result places a governmental unit's compliance failure at a position worse than the compliance failure of many taxpayers. This is particularly inappropriate since by definition the issuer's compliance failure is not due to willful neglect. The Committee recommends that where a penalty is assessed for failure to pay rebatable arbitrage, the correction amount that must also be paid not include any interest charge component. Under this recommendation the issuer would pay interest at the underpayment rate, which is, in effect, a penalty rate.

6. Recovery of Overpayment.

The portion of the Rebate Regulations addressing recovery of overpayments of rebate payments has been reserved. However, the Preamble states that rebate payments are not refundable except where an overpayment is the result of a mistake, such as a mathematical error. Even in this circumstance, no recovery will be permitted unless the Commissioner is satisfied that (i) an amount has been paid in excess of the rebatable arbitrage determined as of the date before the payment (in certain cases, as of the immediately preceding rebate computation date) and (ii) the recovery would result in no rebatable arbitrage as of the date the recovery was first requested.

Comments:

The Committee believes that all overpayments of rebate payments should be refundable, not just overpayments arising as a result of a mathematical error. An issuer should be placed in no worse position than ordinary taxpayers who are entitled to a refund (or credit) against tax for overpayments due to mistaken estimates of income and income tax liability.

The Committee expresses no view in this report as to whether the Rebate Requirement is a tax for purposes of Article I, Section 8 and Article XVI of the U.S. Constitution or any provision of the Code or other law. The Committee does suggest that resolution of the question is not prejudiced by implementing the Rebate Requirement in accordance with appropriate procedural and administrative provisions of the Code. Indeed, the Rebate Regulations reflect a willingness to borrow from certain of these Code provisions. See section 5. “Penalty in the Nature of Interest,” above; see also Rebate Regulations Section 1.148-8T(b)(1)(iv), which in practical effect allows the Commissioner to accelerate the due date for payment of rebatable arbitrage, much like a jeopardy assessment.

It is appropriate to adopt the federal tax law concept of overpayment of refunds or credits for purposes of the Rebate Requirement. From the definition of rebatable arbitrage in Code Section 148(f)(2), it is clear that Congress intended to exact a charge equal to municipal bond arbitrage profits, and not to take any part of the capital used to generate those profits or investment returns equal to the cost of earning those profits. The installment payment rule of Code Section 148(f)(3) does not prohibit recovery of overpayments. The rule requires that cumulative installment payments “shall be paid” in an amount equal to 90% of the rebate requirement computed as of the current installment date. The rule then provides that the last installment shall be in an amount sufficient to pay “the remaining balance of the amount described in paragraph (2)” (i.e., the definition of the rebate amount set forth in Code Section 148(f)(2)). The import of the foregoing is that Congress did not intend to impose a rebate liability in excess of the total arbitrage profits of a bond issue and that for a remaining balance of zero or greater to exist on the last installment date, the intent must have been to permit recovery of excess installment payments or credits against later installment payments. The 10% holdback in respect of installment payments should be viewed not as a substitute for recovery of overpayments but as a supplement to it in order to reduce the administrative burden of processing claims for refund or credit. If the Treasury Department is concerned that it lacks statutory authority to refund rebate payments, it should seek a continuing appropriation to authorize such refunds.

Part V. IMPUTED RECEIPTS

For purposes of computing the non-purpose receipts attributable to investments (see Section 3. of Part II), the Rebate Regulations contain certain rules with respect to "imputed receipts." These miles contain their own separate set of definitions. The term "gross proceeds" (see Section 2. of Part I) above, for purposes of determining imputed receipts, excludes amounts that under Treasury Regulations Sections 1.103-13 and -14 cannot be invested at a "materially higher yield" and amounts on deposit in a reserve or replacement fund (other than as part of a bona fide debt service fund). Rebate Regulations Section 1.148-5T(b)(5).

The general rule with respect to imputed receipts has been reserved and is not contained in the Rebate Regulations. Presumably, investments that are not acquired at fair market value pursuant to the requirements discussed in Section 5. of Part II, above, will give rise to imputed receipts in an amount equal to the difference between (i) the amount that would have been earned assuming the investments had been invested at a market rate of interest and (ii) the actual amount earned. The Rebate Regulations provide guidance concerning the amount of imputed receipts in the advance refunding context, discussed below.

The imputed receipt rules of the Rebate Regulations provide certain safe harbor rules for investments of gross proceeds on deposit in three different types of accounts:

> (1) Non-purpose receipt account, defined as a demand deposit or similar account with a bank, trust company or broker where substantially all of the amounts in the account are invested for five business days or less before being reinvested at a market rate for thirty days or more in non-purpose investments (other than demand deposits).
>
> (2) Purpose receipt account, defined as an interim investment account as in (1), above, except that the reinvestments for thirty days or more are in acquired purpose investments rather than non-purpose investments.
>
> (3) Checking account, defined as a checking or similar account where substantially all of the funds are transferred thereto no earlier than five business days before the funds are used to pay expenditures. Rebate Regulations Section 1.148-5T(b)(3).

The Rebate Regulations provide that no imputed receipts arise with respect to gross proceeds of an issue in a non-purpose receipt account on any day during a calendar month if the average daily balance in the account during the month does not exceed the greater of (i) $10,000 and (ii) the lesser of (I) 10 percent of the unspent gross proceeds of the bond issue, and (II) $50,000. Rebate Regulations Section 1.148-5T(b)(1). The Rebate Regulations also provide that no imputed receipts arise with respect to investments of gross proceeds of a bond issue in a non-purpose or purpose receipt account or checking account on any day during a calendar month to the extent such receipts would cause the investment yield during such month to exceed the bond yield provided that the average daily balance in the account during such month does not exceed the greater of (i) $250,000 and (ii) the lesser of (I) 10 percent of the unspent gross proceeds of the bond issue and (II) $2,500,000. Rebate Regulations Section 1.148-5T(b)(2).

For purposes of applying the aforementioned imputed receipt rules, multiple non-purpose receipt accounts, purpose receipt accounts and checking accounts in which gross proceeds of an issue are invested, are treated as, respectively, one non-purpose receipt account, purpose receipt account and checking account. Rebate Regulations Section 1.148-5T(b)(4). Neither of the safe harbor rules referred to in the previous paragraph apply to an account if all or any portion of the account is formed or availed of for the principal purpose of taking advantage of the safe harbor rules. Rebate Regulations Sections 1.148-5T(b)(3)(iv) and (4).

Comments:

As discussed in Part 11(5), the Committee suggests that there should be a uniform set of market price rules for purposes of determining whether purchases and dispositions of investment property, whether deemed or actual, are at fair market value. The Committee recommends that the imputed receipt rules should be drafted in a manner that is simple and straightforward to enable issuers to comply without the expenditure of large amounts of time and money.

PART VI. ALLOCABLE AND ACCOUNTING RULES

1. In General.

While most of the rules for allocating proceeds to an issue and to investments and expenditures are reserved (except in the context of advance refundings), the Preamble to the Rebate Regulations provides that forthcoming regulations will accommodate customary governmental accounting practices to the extent possible. The Preamble to the Rebate Regulations provides as an example that general purpose governmental units may normally commingle bond proceeds and other funds for investment purposes and allocate earnings to each source of funds on an arm's length basis (e.g., in a manner similar to that of a widely held mutual fund). This method of accounting for bond proceeds is available to determine the amount of rebatable arbitrage, unless (i) the investment fund is formed or availed of for purposes of distorting the amount of rebatable arbitrage, or (ii) the fund principal consists of bond proceeds of an advance refunding.

Comments:

Given that the basic computation of the amount of rebatable arbitrage depends upon a determination as to which proceeds are allocated to an investment and which proceeds are excluded from the rebate calculation as a result of being deemed spent, the Committee urges the IRS to provide immediate guidance to issuers as to which investments and which expenditures may be allocated to gross proceeds of an issue. The Committee recommends that issuers which use funds directly for specific expenditures be allowed to consider these expenditures to be made as of the date the issuer allocates these specific expenditures to specific investments. In addition, the Committee recommends that the IRS provide immediate assurance to issuers which use their normal methods of accounting and allocation that these methods will be respected for purposes of Section 148(f) of the Code. This is another area where there are no perceived abuses and, where there are abuses, such deviations should be dealt with individually apart from the general rules.

The Preamble to the Rebate Regulations invites public comments regarding the scope of an exception to the definition of gross proceeds for investment earnings that are commingled with substantial other revenues of the issuer. Treasury Regulation Section 1.103-13(b)(2)(ii)(B) provides that amounts received from the investment of proceeds of an issue will not be considered investment proceeds of an issue if such proceeds are commingled with other non-bond proceeds within one year of receipt and are not in an advance refunding escrow. The Committee suggests that a similar rule be adopted in the arbitrage rebate context. Municipal issuers have short-term financing needs for which investment proceeds may be used and if earnings are not needed to service debt on outstanding tax-exempt bonds, these amounts should not be treated as gross proceeds of any issue.

2. <u>Allocation Rules for Checking or Similar Accounts</u>.

Rebate Regulations Section 1.148-4T(a) provides a general rule that an investment is allocated to an issue for the period that begins on the date gross proceeds are allocated to the bond issue and the investment and ends on the date such gross proceeds cease to be allocated to such issue or such investment. An expenditure of proceeds in a checking or similar account may be treated as made (i) on the date a negotiable check is written provided that it is actually delivered or mailed no later than one business day after such date, or (ii) on the date the check is delivered or mailed, if the payor has no reason to believe that the check will not clear within a reasonable period of time thereafter. Rebate Regulations Section 1.148-4T(c)(2).

<u>Comments</u>:

The Committee believes that this rule is unworkable because it forces an issuer to ascertain the date a check is actually mailed from its offices. The Committee suggests that for these purposes issuers be allowed to rely on their normal business practices as to accrual of expenditures (subject to those practices normally complying with the one day requirement). Only if there has been a departure from preexisting practices should there be a delay in claiming an expenditure.

It should be noted that this rule has significance primarily as a complement to the rule, discussed above, that amounts deposited in a checking account will not give rise to imputed receipts if such amounts are expended within five days of their deposit into the checking account. Evidently there is a concern that giving a bank a one or two day interest free float may effect a diversion of arbitrage profits. Consideration should be given to a safe harbor exempting small issuers from this requirement.

3. Use of Proceeds to Fund an “Investment Fund”.

The Preamble states on page 57 that “issuers should be aware that the use of proceeds of an issue to fund an investment fund does not result in a reduction in the amount of the unspent gross proceeds of the issue.” Under present interpretations of the law, proceeds of an issue are deemed spent upon the issuance of bonds to reimburse prior expenditures made in anticipation of bond financing. This statement in the Preamble suggests that proceeds of any reimbursement issue may be subject to rebate if the proceeds are used to fund an “investment fund.”

Comments:

The Committee believes that it is inappropriate to subject proceeds of reimbursement bonds to rebate, if this is what was intended, until urgently needed guidance is given concerning the permitted use of reimbursement bonds. If it is the intent of the IRS to subject proceeds of reimbursement bonds to rebate (the authority for and appropriateness of which the Committee would dispute), immediate clarification is requested by means of the notice referred to herein above, concerning the use of the term “investment fund.”

PART VII. REFUNDINGS UNDER THE REBATE REGULATIONS

1. General.

Advance refundings may be accomplished in many different ways. In a complete defeasance, proceeds of the refunding bonds (sometimes together with other funds) are used to fund an escrow with investments such that the principal and interest from the investments will be sufficient to pay all debt service (including redemption premium) on the refunded bonds. Following such a complete defeasance, the security provisions of the indenture for the refunded bonds no longer apply. If the refunding is designed to achieve interest savings by reducing the borrower's interest costs to the lower coupon refunding debt on the first call date for the refunded bonds and it is not necessary to defease the security provisions of the prior indenture, the refunding may be structured as a partial defeasance. In that case, the investments in the refunding escrow will generate principal and interest receipts sufficient to pay all debt service on the callable bonds, but no debt service will be paid from the escrow on bonds maturing prior to the call date for the refunded bonds. Finally, an advance refunding may be structured as a cross-over refunding. In this case the escrow receipts will pay principal on the refunded bonds and interest on the refunding bonds until the call date. In effect, the escrow secures the refunding bonds until the call date. In a cross-over partial refunding, the escrow will pay principal only on the callable bonds.

The Rebate Regulations contain many rules which specifically pertain to refundings. Some of these rules are intended to accommodate the rebate computation rules to the special character of advance refunding transactions. However, several of the rules discussed herein below are not concerned with the computation of rebatable arbitrage under the Rebate Requirement, but rather, with stopping refunding techniques that the Treasury Department perceives as abusive under Treasury Regulations Sections 1.103-13, 1.103-14 and 1.103-15 (hereinafter referred to as the "Yield Restriction Regulations").

Prior to the 1986 Act, it was possible to refund tax-exempt bonds numerous times. Under the 1986 Act, current refundings remain unlimited; but bonds may generally be advance refunded only once. For bonds issued before 1986, however, a minimum of two advance refundings is permitted; and one advance refunding after 1985 is allowed regardless of the number of advance refundings that may have occurred prior to 1986.

Under the Rebate Regulations, if any part of the proceeds of an issue is used to pay principal or interest on another issue, the issue is a refunding issue. Rebate Regulations Section 1.148-8T(f)(1)(i). This definition is broader than the definition of refunding for purposes of the Yield Restriction Regulations and can lead to different characterization and analysis of the same transaction under the two sets of rules. For example, an issue of obligations for the sole purpose of paying one year's interest or a certain amount of capitalized interest on another issue is not a refunding under the Yield Restriction Regulations, but is treated as a refunding under the Rebate Regulations. In such a transaction, there would be no “transferred proceeds” (see subsection 2. below) for purposes of the Yield Restriction Regulations, although “transferred proceeds” may arise for purposes of the Rebate Regulations.

2. Transferred Proceeds.

(a) Prior Transferred Proceeds Rules.

Because prior law permitted multiple advance refundings, it was quite common, at the time a new issue of advance refunding bonds was issued, for investments still to be on hand in an escrow created by a prior advance refunding issue. In some cases the interest rates on the new bonds would be lower than the interest rates on the refunded bonds (a high to low or interest rate savings refunding) and in other cases they would be higher (a low to high or defeasance refunding).

Treasury Regulations Section 1.103-14(e)(2)(ii) provides that at the time that proceeds of the refunding issue “discharge the outstanding principal of the prior issue, proceeds of the prior issue become proceeds of the refunding issue (hereinafter referred to as 1 transferred proceeds *) and cease to be proceeds of the prior issue.” Thus, in a case where the prior issue was itself an advance refunding issue (first refunding issue), proceeds of that issue invested in a refunding escrow (first escrow) would be transferred to i.e., allocated to) the new refunding issue (second refunding issue). The yield on investments in the escrow funded by the second refunding issue (the second escrow) would be combined with the yield on investments in the first escrow allocated to the second refunding issue. The composite yield computed by combining the two sets of investments could not exceed the yield on the refunding issue by more than a *de minimis* amount.

In a low to high refunding, the foregoing transferred proceeds rule would result in lower yielding investments in the first escrow being allocated to the second refunding issue. This would permit the investments in the second escrow to be invested at a yield in excess of the yield on the second refunding issue (a transferred proceeds benefit). But in the more common high to low refunding, the application of the transferred proceeds rules necessitates an investment of the second escrow at a yield below the yield on the second refunding issue (a transferred proceeds penalty).

(b) *The Problem*.

Because a transferred proceeds penalty would reduce the interest rate savings achieved in high to low refundings, numerous refunding structures have been designed to reduce or eliminate the transferred proceeds penalty. One common such structure approved by some but not all counsel allocated proceeds of the second refunding issue to the payment of interest on the first refunding issue, while allocating other available funds to the payment of principal.

Provided those allocations were respected, under the literal language of the transferred proceeds rule no transfer would occur because no principal was being paid by proceeds of the second refunding issue. Arguably, such transactions were inconsistent with the purpose of the transferred proceeds rule, since they permitted issuers to maximize transferred proceeds benefits in a low to high refunding and to minimize transferred proceeds penalties in a high to low refunding.

(c) <u>The Rebate Regulations</u>.

Rebate Regulations Section 1.148-4T(e)(2)(i) provides that “at the close of business on the date that any amount of the proceeds of a refunding issue are used to discharge the principal or interest on or the retirement price of any bond that is part of a refunded issue, the same amount of the proceeds of the refunded issue shall cease to be treated as proceeds of the refunded issue and shall be treated as transferred proceeds of the refunding issue.” Because the proceeds of a refunding issue will include both amounts received from the sale of the refunding issue (“original proceeds”) and earnings received from the investment of those proceeds (“investment proceeds”), the aggregate amount available to pay debt service on the refunded bonds will greatly exceed the original proceeds of the refunding bonds. To prevent the transfer of an excessive amount, Rebate Regulations Section 1.148-4T(e)(2) (ii)(C) contains a transfer cap (which is discussed below). However, keying the transfer mechanism to the total debt service paid on the refunded bonds greatly accelerates the rate at which proceeds transfer from the refunded bonds to the refunding bonds.

The Rebate Regulations also amend the prior transferred proceeds rules in another respect that further greatly accelerates the transfer rate and magnifies the amount of transferred proceeds in the case of a partial refunding. One of the "operating rules" in Treasury Regulations Section 1.103-14(e)(1)(ii)(C) provides that in a partial refunding, the refunded portion of the prior issue and the non-refunded portion of the prior issue are to be treated as separate issues, with unspent proceeds of the prior issue being allocated pro rata between those separate issues. The result prior to the Rebate Regulations was that in a partial refunding of a prior refunding issue only a pro rata portion of the investments in the first escrow would be transferred to the second refunding issue. But Treasury Regulations Section 1.148-4T(f)(1)(ii) defines a "refunded issue" as an issue of which any portion is discharged with the proceeds of another issue and contains no operating rule for treating the refunded and unrefunded bonds as separate issues. Thus, under the Rebate Regulations, the entire amount of the first escrow investments may transfer over in a partial refunding. As discussed below, this rule will be amended in a limited respect as described in Advance Notice 89-78.

(d) General Comments.

The Committee believes that the new transferred proceeds rules should be withdrawn in their entirety and the prior operating rule reinstated with modifications. The new transferred proceeds rules impose economic penalties on issuers for refundings that are unrelated to the statutory rules, are extraordinarily complex and attempt to solve a problem that has been largely legislated out of existence. The effort it would take by the public finance community to make these new rules workable is grossly out of proportion to the benefit to be derived by the Treasury Department or anyone else from doing so.

The Committee believes that a more appropriate change would be to preserve the principle that proceeds should transfer proportionately to the retirement of the refunded bonds, while eliminating artificial distinctions between payments of principal and payments of other debt service amounts. This could easily have been accomplished by using the ratio of debt service being paid to all debt service remaining payable (or to the present value thereof). Alternatively, the old principal-to-principal rule could be retained but payments of debt service would have to be allocated pro rata between the available sources of funds to pay debt service. In addition, it is essential that the Rebate Regulations preserve the rule requiring a pro rata allocation of unspent proceeds of the refunded issue between the refunded and unrefunded portions of the refunded bonds. That rule is consistent with the principle of proportionality. The debt service that would be taken into account under our first suggestion (transfers in proportion of funded debt service to remaining debt service) would then be limited to debt service on the refunded portion of the prior bonds.

The transferred proceeds penalties resulting from the transferred proceeds changes in the Rebate Regulations go well beyond matching investments to the outstanding bonds and impose outright economic penalties for refundings in many instances. Where the bonds now being refunded were low to high advance refunding bonds, the prior refunded bonds will have been defeased but will have been left outstanding until maturity. Thus, the investments in the first refunding escrow will have much longer average maturities than the investments in the second refunding escrow. This creates the potential for very large transferred proceeds penalties, which are accelerated and magnified by the Rebate Regulations. The Committee submits that this effect of the Rebate Regulations is contrary to the decision of Congress in the 1986 Act to permit governmental issuers to issue at least one additional issue of advance refunding bonds. In many cases, the Rebate Regulations make economically unfeasible what Congress chose to permit.

Moreover, it should be noted that in the high to low situation the issuer continues to bear the borrowing cost of the prior issue to the first call date; is unable to recover all costs of issuance (except certain credit enhancement fees, if any) from the yield on the refunding bond proceeds' escrow investments; loses the temporary period on the construction fund proceeds, if any; and is penalized by a disproportionate transferred proceeds penalty for a multiplicity of reasons under the new transferred proceeds rules (e.g., transfer of the entire prior issue reserve fund notwithstanding a partial refunding).

Finally, it should be reiterated that the impact of the Rebate Regulations in advance refundings of advance refunding bonds is essentially a transitional problem relating to bonds issued before 1986, since double advance refundings are prohibited for bonds issued after 1985. The issuers of such pre-1986 bonds may have elected to issue high coupon bonds with the expectation that they would be able to convert to lower cost debt through an advance refunding. In effect, the changes in the transferred proceeds rules have a largely retroactive effect on issuers of bonds that are not themselves subject to the rebate rules.

(e) Technical Comments.

(i) Multiple borrower issues. It is not uncommon to issue bonds to make loans to more than one private user. For example, multi-family housing bonds may finance several different housing projects sponsored by different developers. If there is a current refunding for the portion of the bonds issued to finance one project, it is possible under the Rebate Regulations as originally published that the entire reserve fund will become transferred proceeds of the refunding issue. As a result, one developer could have become responsible for rebating the arbitrage on the entire reserve fund even though, at most, the developer would have benefitted only from the arbitrage on the portion of the reserve fund allocable to the particular project.

Advance Notice 89-78 indicates that the Rebate Regulations will be amended by adding a limited exception to the general rule applying the transferred proceeds rule to the

the entire unexpended proceeds of a prior issue in a partial refunding. Under this exception, the portion of a prior issue properly allocated to a “conduit purpose investment” will be treated as a separate issue for purposes of both the refunding allocation rules and the transferred proceeds rules. A “conduit purpose investment” is defined as an “eligible purpose investment” within the meaning of the guarantee rules discussed above, which meets the requirement in the guarantee rules that payments on the investment coincide in time with payments on the bonds. This definition excludes student loan bonds and single-family housing bonds; it also excludes cases in which the issuer has relied on the 150 basis point spread available for program investments rather than the 1/8 of one percentage point spread limitation generally applicable. The latter exclusion means that this conduit rule will not be available for certain bonds issued to finance multiple housing projects or facilities for tax-exempt entities (principally hospitals and educational institutions), the primary cases involving program investments.

The Committee recommends that the definition of conduit investments be broadened to include program, as well as non-program, investments. There are no readily apparent policy reasons for the exclusion of acquired program investments from the operating rule for conduit purpose investments. There seems to be a consistent denial of the special rules applicable to program investments throughout the Rebate Regulations (see Part 11(1)), perhaps based on a view by certain Treasury officials that the 150 basis point spread somehow disproportionately inures to the benefit of issuers through enhanced fees. In fact, electing the 150 basis point spread usually has no impact on issuer processing and acceptance fees, but rather, is a choice based on the additional administrative costs inherent in any ongoing program. The exclusion of program investments but not non-program purpose investments from the conduit purpose investment operating rule simply serves as a penalty to program issuers. The conduit purpose investment operating rule makes economic sense in the context of the refunding allocation rules and the transferred proceeds rules. To deny program investments the benefit of the conduit purpose operating rule will prevent legitimate re-financings of certain program obligations (that would otherwise enable program fees to be reduced).

(ii) Transfer Cap. Treasury Regulations 1.148-4T(e)(2)(ii)(C) provides that “in the case of a refunding issue to which 149(d)(4) applies, paragraph (e)(2)(i) of this section shall not apply on a date to the extent that it would cause the value of the non-purpose investments allocated to the refunding portion of the issue to exceed by more than 10 percent the value of the bonds allocated (on a pro rata basis) to the issue.”*

In an advance refunding of an advance refunding, this provision requires a set of very complicated calculations. As an

* As discussed more fully herein below, this rule has been changed by Advance Notice 89-78.

illustration, assume that the second refunding issue is solely a partial refunding issue with both interest and principal being paid out of the second escrow. Assume also that investments remain in the first escrow and that periodic payments are being made out of that escrow on the bonds refunded by that escrow.

Application of the transfer cap requires the following calculations. First, the value of the refunding bonds must be established by computing the present value of each bond from the date of issue of the refunding bonds to the early retirement date for each such bond. Second, on the initial transfer date, the value of the investments in the first escrow must be determined using the actual composite yield on the restricted investments in the first escrow. Third, using that value as the denominator and the transfer amount (i.e., the amount of debt service paid out of the second escrow on the first refunding bonds) as the numerator, a fraction is derived. That fraction is then multiplied by each future cash receipt in the first escrow to determine the receipts that constitute the transferred investment allocable to the transferred proceeds. (Ultimately the composite yield calculations for the combination of the second escrow and the transferred proceeds will take into account the amount of the transferred proceeds as the purchase price of an investment and the future cash receipts as yield.) The amount of the transferred proceeds plus the present value of the investments in the second refunding escrow (determined at the yield on the second escrow) is then compared to the value of the bonds.[*] These steps are then repeated on each subsequent date. But cash flows previously transferred will first have to be subtracted from the first escrow. And because the value of the investments in the first and second escrows will change by virtue of payments being made out of the escrows in amounts that do not equal the separate composite yield of each of the escrows, it is necessary to revalue both escrows on each transfer date and to revalue the cash flows allocable to transferred proceeds previously transferred. Similarly, the refunding bonds must be revalued on each transfer date.

While the described steps involves multiple calculations for constantly changing cash flows, it may appear to be something a computer could accomplish readily. On each transfer date, the program would calculate the present value of the still outstanding refunding bonds, multiply that value by 110%, and subtract the present value of the remaining cash flows attributable to prior transfers and to investments remaining in the second escrow. The maximum transfer amount would then be the

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[*] In a triple refunding (the refunded bonds were themselves a second advance refunding), it is also necessary to value the transferred proceeds from the first refunding issue to the second refunding issue. The use of the separate escrow yields, rather than the composite yield of the combination of the first escrow transferred proceeds and the second escrow proceeds follows from the rule for rebate purposes that the determination of whether proceeds are in an escrow is made without regard to transferred proceeds. See Treasury Regulations Section 1.148-8T(g)(4)&(5), Example 1, together with the rule requiring the yield on a restricted escrow to be used in determining the value of investments in the escrow. Treasury Regulations Section 1.148-2T(d)(3).

lesser of the amount of debt service paid on the refunded bonds or the amount so calculated. The problem is that this calculation is superimposed on an already difficult interacting calculation in which the transferred proceeds penalty determines the maximum yield in the second escrow, which affects the required size of the bond issue, which may affect the yield on the bonds, which again affects the maximum yield in the second escrow. The Committee understands that investment banking firms are finding it very difficult to program computers to solve this problem. The problem is obviously further compounded in a scenario with multiple refundings with funds from multiple sources which are expended over time in amounts that are unpredictable and thereby change the transferred proceeds penalty — requiring the issuer to continuously keep rerunning the transferred proceeds calculation until all the funds are expended.

Because the transfer cap in the Rebate Regulations as originally published took into account all investments allocated to the refunding bonds, investments in a debt service fund could have reduced transferred proceeds. Thus, an issuer could have avoided the intended effect of the rule by scheduling debt service payments on the refunding bonds a day later than debt service payments on the refunded bonds. Advance Notice 89-78 attempts to amend the transfer cap rules to eliminate this problem, but the amendment fails to solve the problem entirely.

Advance Notice 89-78 would reduce the transfer cap to 100% and eliminate from consideration “investments allocated to gross proceeds (other than proceeds)....” Accordingly, a reserve fund derived from proceeds would not be taken into account (the necessity of dealing with such a reserve fund was the reason for the 10% additional amount). Also excluded would be a debt service fund derived from proceeds. Because proceeds have now been broadly defined to include “any amounts actually or constructively received from investing original proceeds [including investment proceeds] of the issue,” the debt service fund for most revenue bond issues would be excluded. That is, revenue bond issues generally involve an investment in purpose obligations, and payments on the purpose obligations deposited in a debt service fund would be “proceeds.” But the amendment fails to cover most debt service funds for general obligation issues financing public facilities, since monies deposited in such funds are generally derived from tax receipts rather than receipts generated by the investment of bond proceeds. The Committee recommends that this omission be corrected.

A return to a proportional transfer rule would eliminate these technical problems with both multiple user issues and the transfer cap.

The transfer cap applies only in the case of a refunding issue to which section 149(d)(4) applies. Rebate Regulations Section 1.149-1T(d)(2) indicates that section 149 applies to any advance refunding bond issued after August 31, 1986. While a transfer cap is not needed in a current refunding, it is unclear why. it was thought necessary to specifically exclude application of the transfer cap to such refundings.

The arbitrage rebate provisions apply to nongovernmental bonds issued after December 31, 1985. While the transferred proceeds provisions of the Rebate Regulations generally apply to bonds sold after May 15, 1989 or issued after June 14, 1989, those provisions apply retroactively to one type of refunding issue which is apparently deemed to be abusive. If the reference to bonds to which section 149(d)(4) applies is intended to make the transfer cap inapplicable to such abusive refunding bonds issued between December 31, 1985 and September l, 1986, that intent should be made more explicit.

3. Anti-Netting Rule for Negative Arbitrage on Escrow Investments.

As a general rule, the Rebate Regulations compute rebatable arbitrage by comparing the future value of all receipts on non-purpose investments to the future value of all payments for non-purpose investments. In effect, investments producing negative arbitrage can be netted against investments producing positive arbitrage to determine the rebate amount.

However, under the Rebate Regulations, negative arbitrage on escrow investments and, for the period they are subject to yield restriction, reserve fund investments acquired with advance refunding bond proceeds cannot be netted against positive arbitrage on other investments allocable to the refunding issue (e.g., positive arbitrage on construction fund investments in a multi-purpose new money-refunding issue of bonds). Rebate Regulations Section 1.148-2T(b)(5)(i). Also subject to this anti-netting rule are (i) refunded issue proceeds that become transferred proceeds of the refunding issue and are invested in the advance refunding escrow, and (ii) revenues invested in the advance refunding escrow or a long-term sinking fund for the bonds (other than a bona fide debt service fund or a reasonably required reserve fund to cover temporary shortfalls of revenues). Thus, negative arbitrage on investments allocable to such amounts cannot be used to offset positive arbitrage on the other investments allocable to the issue. Rebate Regulations Section 1.148-2T(b)(5)(i)(B),(ii).

The Rebate Regulations contain a special exception to the anti-netting rule where lower yielding refunding bonds (the “second refunding issue”) are issued at or shortly prior to the date their proceeds are used to discharge higher yielding advance refunding bonds having unexpended proceeds invested in an escrow. In such case, the spread between the higher yielding escrow investments (which after the discharge date are allocated to the second refunding issue under the transferred proceeds rule) and the lower yielding refunding bonds must be eliminated pursuant to the Yield Restriction Regulations. Therefore, revenues must be invested at a low yield in a yield-restricted sinking fund for the second refunding issue to average down the yield of the escrow investments. However, the issuer would be penalized twice (first by investing the sinking fund at low yields and second by paying rebatable arbitrage on the high yielding escrow investments) unless netting of the sinking fund and escrow investments is permitted for rebate purposes. Accordingly, the Rebate Regulations permit netting, provided that the sinking fund investments at all times consist of (to the extent practical) zero-yield SLGs. For transactions sold on or before May 15, 1989 and issued on or before June 14, 1989, the sinking fund SLG investments may be yield bearing.

Comments:

The Committee recommends that revenues invested in long-term sinking funds allocable to the refunding issue be exempt from the anti-netting rule in the final regulations. Where an issuer has set aside such revenues in such a manner so as to assure their availability for use with respect to the refunding issue, there is no policy reason to deny the issuer the right to blend yields on such investments with those of the refunding issues.

4. Allocation Rules for Refundings.

The Rebate Regulations contain specific rules governing the use in a refunding of certain amounts other than proceeds of the refunding issue. These other amounts are, first, sale proceeds and investment proceeds of the refunded bonds that remain unexpended as of the issue date of the refunding bonds and that the issuer deposits in the escrow to pay debt service on the refunded bonds. Second, the allocation rules apply to revenues that at, or within six months of, the issue date of the refunding bonds are or were on deposit in a debt service fund, reserve fund or other sinking fund for the refunded bonds, unless (i) the amounts have been placed in a sinking fund for the refunding issue, or in a defeasance fund for the refunded issue created at least six months before the issue date of the refunding, or (ii) the amounts remain in a reasonably required reserve fund or a bona fide debt service fund for the refunded issue (i.e., the transaction is a "cross-over" refunding). The Rebate Regulations prohibit the transfer of amounts in a bona fide debt service fund for the prior issue to a sinking fund (including a bona fide debt service fund) for the refunding issue.

In respect of sale proceeds and investment proceeds of the refunded bonds which, at the time of the refunding, the issuer deposits in the escrow to pay the debt service of the refunded bonds, the Rebate Regulations require that such proceeds be allocated to investments that mature and are expended before any investments acquired with refunding bond proceeds mature (generally, hereinafter referred to as the "spend-faster rule"). The Rebate Regulations further mandate that unspent proceeds of the refunded issue which were to be used to pay certain capitalized interest of the refunded issue must be placed in the escrow and invested in the manner described above. Rebate Regulations Section 1.148-4T(e)(1)(ii),(iv)(B).

In respect of revenues that are or were on deposit in a debt service fund, reserve fund or other sinking fund for the refunded bonds and are not otherwise used in a manner excluding them from the allocation rules, the Rebate Regulations require that such amounts be deposited in the escrow to pay debt service on the refunded bonds and that they be allocated to investments that mature and are expended before any investments acquired with refunding bonds proceeds mature. Rebate Regulations Section 1.148-4T(e)(1)(i),(ii).

Comments:

The spend-faster rule (requiring short-term escrow investments) has two adverse effects in the context of a refunding for interest rate savings. First, the reduced cash flow resulting from the required use of short-term investments will mean that such amounts will be less effective for reducing the transferred proceeds penalty under the new transferred proceeds rule in the case of a refunding of an issue that itself is a refunding issue.

Second, in cases where the funds in question could have been invested for a longer period at a higher yield, the allocation rules eliminate the potentially higher yield.

In a high to low refunding, the yield restriction applicable to funds allocable to the prior issue will be higher than the yield restriction applicable to the investment of refunding bond proceeds; and these rules have the effect of requiring the elimination of the higher yielding investments first. Because the issuer would presumably elect to spend amounts allocable to the prior bonds first in the case of a low to high refunding, an argument can be made that the spend-faster rule is fair. Moreover, in many cases similar results would have been achieved by a replacement analysis under the Yield Restriction Regulations or under the new rules respecting use of abusive devices in connection with advance refundings.

The Committee wishes to stress, however, the lack of a sound economic basis for this spend-faster rule. It is apparent that the rule provides a disincentive to issuers to contribute available funds as equity to a refunding escrow. To that extent, the rule increases the amount of refunding bonds issued to compensate for this lack of equity. This results in a potentially greater economic detriment to the Treasury than simply allowing such non-bond proceeds to be invested throughout the life of the escrows.

The Rebate Regulations' special allocation rules for refundings do not address transactions in which unspent sale or investment proceeds of the refunded issue or unspent revenues in a pledge fund for the refunded issue are released to the issuer at the time of the refunding. However, the Preamble to the Rebate Regulations observes that the release of such amounts might give rise to “replacement funds” of the refunding issue.

Technical Comments.

The Committee believes that the definition of “excess proceeds” set forth in Rebate Regulations Section 1.148-4T(c)(1)(iv) is circular. Proceeds of a refunded issue are “excess proceeds” if, among other things, such proceeds are allocated to investments described in paragraph (e)(1)(i) of Rebate Regulations Section 1.148-4T. But the cross-referenced paragraph is the provision requiring excess proceeds to be allocated to such investments. Also, using the term “excess proceeds” is confusing given that the term already has established a different meaning under Treas. Regs. Section 1.103-15.

5. Imputed Escrow Receipts.

In two types of situations, the Rebate Regulations impute additional receipts to tax-exempt and taxable investments in an advance refunding escrow and to proceeds of an issue or revenues invested in tax-exempt and taxable investments in an escrow fund to defease (legally or economically) the issue. Any receipts so imputed are taken into account for purposes of determining both the proper amount of rebate and compliance with the Yield Restriction Regulations for the escrow investments.

(a) Interest and Guarantee Fee Savings.

The first type of imputed escrow receipts arises where, as a result of the creation of the escrow to pay outstanding bonds, there occurs either a reduction in future interest payments or guarantee fee requirements in respect of the bonds, or a refund of a portion of such payments previously made. Rebate Regulations Section 1.148-5T(c)(1)(i),(ii). The amount of the imputed receipts are the interest savings or guarantee fee savings occurring during the life of the escrow or, in the case of a refund, the portion of the refund properly allocable (using the constant payment allocation method described in Part 111(9), above) to the period the escrow investments are outstanding. Rebate Regulations Section 1.148-5T(c) (4), Example (3). Such amount of imputed receipts is allocated among escrow investments in accordance with the special allocation rules for refundings (see Section 4. of this Part, above). Thus, where escrow investments are acquired with both advance refunding bond proceeds and other funds, the refunding bond proceed investments will receive the larger allocation of imputed receipts.

Imputed receipts arise from a reduction or refund of guarantee fee payments whether or not the fees could be or were used to adjust the yield of the guaranteed bonds. Rebate Regulations Section 1.148-5T(c)(4), Example (2). However, imputed receipts will not arise to the extent that the interest or guarantee fee saving is eliminated by the payment of a similar amount with respect to the refunding bonds, provided the similar payment is not eligible to be used as a payment increasing the yield of the refunding bonds. Rebate Regulations Section 1.148-5T(c)(1)(i). Interest or guarantee fee savings which are imputed receipts are not taken into account to reduce the yield of bonds with respect to which the savings occur.

Advance refunding transactions creating interest or guarantee fee savings are also described in Senate Report 99-313, 99th Cong., 2d Sess. at 850, as an example of an abusive transaction which violates the condition set forth in Code Section 149(d)(4) for the tax-exemption of advance refunding bonds. The abusive transaction example requires that the savings be used to reduce the yield on the refunding bonds to achieve compliance with Code Section 149(d)(4). By contrast, the Rebate Regulations require that the savings be treated as imputed receipts on the refunding bond investments.

Comments:

Clarification is necessary to assure that both the Rebate Regulations and Code Section 149(d)(4) can be satisfied in this situation without requiring a double adjustment for the same amount of savings.

Pursuant to a transition rule, imputed receipts derived from interest or guarantee fee savings will not arise for any bonds (i) sold on or before May 15, 1989, (ii) issued on or before June 14, 1989, and (iii) with respect to which an escrow was created on or before May 15, 1989. However, the transition rule does not apply to advance refunding transactions resulting in an interest saving or a refund of interest or guarantee fee payments in respect of the refunded bonds which were not taken into account in computing the yield on the advance refunding bonds. For these transactions, the general effective date rule of the Rebate Regulations applies thus increasing the rebate obligation to the extent a double benefit was obtained (see Part IX, below).

(b) Receipts on Tax-Exempt Escrow Investments.

The second type of imputed escrow receipts involves a portion of the receipts on tax-exempt escrow investments acquired with a part of refunding bond proceeds, which portion is reallocated to taxable escrow investments acquired with another part of such proceeds. A similar reallocation rule applies for tax-exempt and taxable escrow investments acquired with revenues or proceeds of the issue to be paid from the escrow. Rebate Regulations Section 1.148-5T(c)(2).

The reallocation of the portion of tax-exempt receipts to taxable investments only occurs if (i) the composite yield on the tax-exempt escrow investments exceeds by more than .125 percent the composite yield on the taxable escrow investments and (ii) the weighted average maturity of the tax-exempt escrow investments (other than those in the escrow for three months or less) is more than 25 percent greater or less than the weighted average maturity of the taxable escrow investments (other than those in the escrow for three months or less). If the foregoing conditions are met, the amount of tax-exempt receipts reallocated to the taxable investments are all of the receipts in excess of the amount necessary to produce the above .125 percent yield differential.

Comments:

The Committee believes that including tax-exempt escrow receipts within the definition of “imputed escrow receipts” is beyond the scope of the statute. See Code Section 148(b)(2). Accordingly, the Committee recommends deletion of this portion of the definition in the final regulations.

6. Indirect Use.

The Rebate Regulations provide an indirect use rule intended to prevent avoidance of the Rebate Requirement through artificial allocations and substitutions of uses of bond proceeds and other funds. Under the rule, any reference to proceeds for purposes of the Rebate Regulations includes a reference to both the direct and indirect use of the proceeds. Further, if proceeds are used directly or indirectly, the proceeds shall be considered used in whatever manner produces the largest amount of rebatable arbitrage. Rebate Regulations Section 1.148-8T(d)(9).

The Preamble to the Rebate Regulations suggests that an indirect use occurs if fully fungible dollars are substituted for other fully fungible dollars solely for tax reasons and the substitution involves a change in the purpose for which the funds are to be used. However, the text of the Rebate Regulations does not define indirect use other than by way of example, so it is not clear that either tax avoidance as the sole motivation or a change of purpose is necessary to trigger an indirect use. Thus, the rule could be pertinent in any situation where bond proceeds are proposed to be allocated to past or future expenditures. The indirect use rule applies to bond issues for new costs as well as refunding bonds.

Examples in the Rebate Regulations illustrate that an indirect use of bond proceeds occurs whenever a substitution is arranged by which (i) the proceeds of a bond issue are deposited in a general fund, general construction fund, pension fund, a construction or reserve fund holding proceeds of an another issue, or an advance refunding escrow holding proceeds of another issue and (ii) other funds or proceeds are deposited in a fund to pay debt service on one of such issues or yet a different issue. Rebate Regulations Section 1.148-8T(d)(9)(ii), Examples.

The indirect use rule applies for purposes of determining the proper amount of rebate in respect of all bonds subject to the general effective date of the Rebate Regulations (see Part IX, below).

The indirect use rule also will be applied to bond issues grandfathered from the Rebate Regulations where the indirect use of the proceeds is to advance refund other obligations, for the purpose of determining which investments are allocable under the transferred proceeds rules to refunding bond issues that are subject to the Rebate Requirement. Rebate Regulations Section 1.148-8T(d) (9)(ii), Example 1.

Comments:

As discussed in Part 1(8), the indirect use rule may be easily circumvented due to the use of the word “solely” for tax reasons. The Committee believes the rule simply “attempts to do too much” thereby inviting creative avoidance among practitioners. If this rule is included in the final regulations, it should be redrafted in much greater detail with more identifiable parameters.

7. Arbitrage Audit of Refunded Bonds.

Rebate Regulations Section 1.148-1T(b)(1)(ii) provides that a refunding issue shall not be treated as meeting the Rebate Requirement unless the Rebate Requirement has been met with respect to the refunded bonds (assuming the refunded bonds were themselves subject to the Rebate Requirement, including the rebate requirement previously applicable to industrial development bonds and single family housing bonds).

The Committee is concerned about the administrative burdens and costs that will be entailed for smaller issuers. By number, the greatest volume of tax-exempt issues are notes rather than bonds. Frequently the papers for a renewal of bond anticipation notes must be prepared on very short notice, so that there is insufficient time to review prior compliance with the Rebate Requirement. Furthermore, the final rebate payment is not due until 60 days after the debt is retired, a date which will occur subsequent to the issue of the refunding bonds. Hence, this requirement will cause counsel to consider qualifying their opinions with respect to the refunding issues.

In many cases refunded general obligation bond anticipation notes will have been exempted from the Rebate Requirement by the small issuer exemption. But a determination that the small issuer exemption applied may itself be burdensome, in that the particular note being renewed may not have been the only tax-exempt obligations issued by the particular issuer during the year. The Committee recommends that the rebate audit rule be eliminated, or at the very least, modified, by adding a broader small issuer exemption along the lines of the special rule for small issuers in Rebate Regulations Section 1.148-3T(c)(4).

The requirement that the refunded issue meet the arbitrage Rebate Requirement applies only when the refunded issue is itself tax-exempt. However, Rebate Regulations Section 1.150-1T(b)(2) provides, for all purposes of the tax-exempt bond provisions of the Code, that “any bond (or issue) that (when issued) purported to be a tax-exempt bond (or issue) shall be treated as a tax-exempt bond (or issue).” Thus, a failure by the refunded issue to satisfy the Rebate Requirement not only makes the refunded issue taxable, it also makes the refunding issue taxable because the taxable refunded issue purported to be tax-exempt.

8. Taxable Refundings.

As noted in the footnote at page 118, above, all of the investments in a restricted escrow are generally treated as having a single, constant yield. This yield is used to determine the present value of investments when they are transferred from refunded bonds to refunding bonds. Other investments are usually marked-to-market when they become allocable to a bond issue or cease to be allocable to a bond issue. If refunding bonds are taxable bonds, the restricted escrow rule does not apply and investments in the escrow created by the refunding bonds are marked-to-market on each transfer date. Rebate Regulations Section 1.148-2T(d)(3)(ii). This rule applies only to refunded bonds sold after May 15, 1989 or issued after June 14, 1989 that do qualify for the small issuer exemption.

In the case of a taxable refunding, the issuer will pay no transferred proceeds penalty (because the rebate requirement does not apply to taxable bonds) but may pay an interest rate penalty (i.e., a taxable as opposed to a tax-exempt rate). In a high to low refunding (i.e., a taxable refunding bond yield below the tax-exempt refunded bond yield), the issuer may also recognize rebatable gains as the prior escrow investments are marked-to-market.

The economic rationale for the position taken in the Rebate Regulations is that when refunding bond proceeds are used to pay debt service on the refunded bonds, the yield on the refunding bonds becomes the appropriate carrying cost to compare with the yield on the transferred investments. The gain computed from the marked-to- market is evidently being used as a surrogate for the present value of the difference in refunding bond and investment yield. However, it is doubtful whether it is a good surrogate because the issuer is paying a taxable rate. The result is that the added rebatable gains from the marked-to-market mechanism are a penalty payable by issuers for undertaking a taxable refunding. From a policy standpoint this penalty makes no sense because one of the key Congressional purposes behind enactment of the 1986 Act was to encourage the issuance of taxable obligations as opposed to more tax-exempt obligations.

The Committee also believes this is a case where theory has been carried too far for another reason. Because the marked-to- market in an advance refunding will occur at numerous points in the future (i.e., on each transfer date), the issuer will be unable to predict what rebate cost will result from the refunding because of the inability to determine the consequences. As a result the rule may effectively prevent most taxable refundings.

PART VIII. ELECTIONS

All issuer elections with respect to a bond issue must be in writing and must be signed by an authorized representative of the issuer on or before the date of issue. For bonds issued on or before November 15, 1989, the issuer election must be made on or before the first date after June 14, 1989 that any amount of rebatable arbitrage with respect to an issue is paid or required to be paid to the United States. All issuer elections are irrevocable. Rebate Regulations Section 1.148-8T(h)(i).

The Rebate Regulations relating to elections contain an unusual procedural requirement. If the rebatable arbitrage with respect to an issue (determined by taking an election into account) is smaller than the rebatable arbitrage (without regard to the election), the election is effective only if the election identifies the applicable bond issue and is maintained as part of the official transcript of the bond issue proceedings until six years after the final computation date (although inadvertent noncompliance may be waived by the IRS). Rebate Regulations Section 1.148-8T(h)(2).

The IRS may extend the time for making an election if the IRS determines: (i) failure to make the election in a timely manner was due to reasonable cause; (ii) as of the date of issue (without regard to subsequent events), the election was in the issuer's best interests and failure to elect was not deliberate; and (iii) the aggregate issue price of the bonds is less than $50,000,000. Rebate Regulations Section 1.148-8T(h)(3)(ii).

Comments:

The Committee recommends deletion as unnecessary administrative regimentation of the procedural rule requiring an issuer election to identify the bond issue and to be maintained as part of the transcript until six-years after the final computation date, if the election decreases the amount of the rebate.

PART IX. EFFECTIVE DATES AND TRANSITIONAL RULES

The Rebate Regulations are generally effective for private activity bonds issued after December 31, 1985 and for bonds other than private activity bonds issued after August 31, 1986. Throughout the Rebate Regulations, however, there are special effective dates for many of the rules. Generally, the rules subject to the special effective dates do not apply to bonds that are sold on or before May 15, 1989 and are issued before June 15, 1989.

The Preamble describes the reasons that the Treasury Department believes support the retroactive effective dates. The primary reason given is that the lack of guidance given in Section 148(f) of the Code would make it difficult for issuers to determine whether they were complying with the requirements and for the IRS to administer the requirements. The Preamble goes on to say that reliance on any guidance given by the existing regulations applicable to certain industrial development bonds was not appropriate since they were not comprehensive, they often produced harsh results and “the results under the new rules are ordinarily more favorable for issuers.” The Preamble mentioned, however, that “several special transition rules [11 to be exact] have been provided to protect issuers that reasonably may have relied on regulations promulgated under Section 103(c) of the 1954 Code from any material adverse effect that might otherwise arise from such reliance.”

Comments:

The Treasury Department through this framework of effective date rules has determined when the applications of the existing arbitrage rules can be relied upon by an issuer. This determination by the Treasury Department is arbitrary in view of the great number and diversity of bonds that have been issued between the effective dates of the 1986 Act and the publication of the Rebate Regulations. Moreover, the selective effective date rules do not take into account the significant amount of effort and expense issuers have undertaken in structuring bond issues and installing arbitrage compliance mechanisms using the existing arbitrage and rebate regulations, including the industrial development bond rebate rules, as guidance.

These expenditures may be small, however, compared to the amounts that may be required by issuers to analyze all affected bond issues under the new regulations and establish new arbitrage rebate compliance mechanisms. This cost should not have to be borne by issuers as a result of the Treasury Department's delay in issuing regulations. Further delays and expense are likely since crucial portions of the regulations, such as those concerning allocations of gross proceeds, expenditures and investments, have not been promulgated.

The Committee recommends that issuers of bonds sold prior to May 16, 1989 and delivered prior to June 15, 1989 be permitted to rely on existing arbitrage regulations if the issuer in good faith determines and pays the rebate due under Section 148(f). Although there is little guidance provided under Section 148(f), there is guidance available in the industrial development bond rebate regulations which have been in place since 1985 and the mortgage revenue bond rebate regulations which have been in place since 1981.

In connection with the refunding of bond issues that were subject to rebate rules other than Section 148(f) of the Code, such as mortgage revenue bonds issued prior to January 1, 1989 and certain industrial development bonds issued prior to January 1, 1986, the new rules may increase the amount of rebate owed with respect to those issues. It does not seem proper for the regulations to affect the rebate liability of a bond issue that is not subject to the regulations. For example, the amount and value of particular investments that transfer in connection with a current refunding may be different under the respective rules. The use of the new transferred proceeds rule may result in a larger rebate liability in connection with the refunded issue than otherwise would be required by the rules applicable to the refunded issue.

Many practitioners are still uncertain as to whether in fact some of the references to refunding issues to which Section 149(d)(4) “applies” were intended by the draftsman to mean refunding issues “described” in Section 149(d)(4). See Rebate Regulations Section 1.148-4T(e)(2)(iii)(B). Section 149(d)(4) prohibits the use of an “abusive device” in connection with an advance refunding. The reference to the application of Section 149(d)(4) in the Rebate, Regulations (e.g., 1.148-4T(e)(2)(ii)(C)) would ordinarily give rise to a presumption that the author is referring to a transaction that is “abusive.” However, Rebate Regulations Section 1.149(d)-1T(d)(2) states that Section 149(d)(4) applies to any bond issued after August 31, 1986 that is part of an advance refunding. Thus, under this regulation a refunding issue to which Section 149(d)(4) “applies” apparently means all post-August 31, 1986 refundings, other than current refundings.

In addition, it seems clear that the overall intent of Rebate Regulations Section 1.149(d)-lT(d)(2) is to apply the new rules governing rebate to post-August 31, 1986 advance refundings, unless a specific transitional rule provides relief. There appears to be an expectation that certain post-August 31, 1986 advance refundings will not comply with the new Rebate Regulations because 1.149(d)-1T(a) states that “....nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in [Section 1.149(d)-1T(d)(2)].”

In order to avoid this confusion, the draftsman should have been more forthright, clearly specified the result intended and permitted this result to be clearly questioned.

The Committee recommends that all references to advance refundings to which Section 149(d)(4) “applies” should be changed to simply refer to advance refundings issued after August 31, 1986. Unless transitional relief is considered appropriate, Rebate Regulations Section 1.149(d)-1T(d)(2) would then refer to all post-August 31, 1986 advance refundings where the new rebate rules have not been met.