COMMENTS ON TEMPORARY REGULATIONS ON ARBITRAGE RESTRICTIONS ON TAX-EXEMPT BONDS (T.D. 8538 and FI-7-94)

The comments in this Report were prepared by the Arbitrage and Rebate Committee of the National Association of Bond Lawyers ("NABL") with the participation of a number of NABL members. Those members who contributed to the preparation of this Report are as follows:

David A. Caprera
David J. Cholst
Dale S. Collinson
William H. Conner
John J. Cross, III
Amy K. Dunbar
Clifford M. Gerber
Richard L. Kornblith
Carol L. Lew
John T. Lutz
Arthur M. Miller
Lisa P. Soeder
David A. Walton

Questions should be directed to David A. Walton, chair of the Arbitrage and Rebate Committee, at (415) 391-5780.

Dated: April 10, 1997

Introduction

This report contains the comments of the Arbitrage and Rebate Committee (the "Committee") of the National Association of Bond Lawyers ("NABL") on the temporary Treasury Regulations regarding Arbitrage Restrictions on Tax-Exempt Bonds (T.D. 8538) (the "Temporary Regulations") published in the Federal Register on May 10, 1994. This report also contains follow-up comments of the Committee on the proposed Treasury Regulations regarding Arbitrage Restrictions on Tax-Exempt Bonds (FI-7-94) (the "Proposed Regulations") published in the Federal Register on July 11, 1994. The comments on the Proposed Regulations are a follow-up to the testimony of John J. Cross, III, delivered at the public hearing that was held on October 12, 1995. The Committee appreciates the opportunity afforded us at the public hearing to express our views on the Proposed Regulations.

NABL was incorporated as an Illinois nonprofit corporation on February 5, 1979, for the purposes of educating its members and others in the law relating to state and municipal bonds and other obligations and participating in national and local forums in order to advise and comment on legislative, regulatory and judicial issues affecting said bonds and obligations. NABL currently has over 2,800 members.

General Comments

It is our understanding that, pursuant to section 7805(e) of the Internal Revenue Code of 1986 (the "Code"), the Temporary Regulations will expire on May 10, 1997, three years after the date of issuance thereof. Because of the impending expiration of the Temporary Regulations and expected action with respect thereto by the Internal Revenue Service, we are submitting these comments and, in addition, commenting on certain provisions of the final regulations under section 148 of the Code (the "Final Regulations") in light of our experience in their application since implementation. As indicated above, we are also commenting on the Proposed Regulations.

§1.103-8T - Interest on Bonds to Finance Certain Exempt Facilities

Rules limiting the use of bond proceeds to reimburse expenditures paid prior to the issuance of a bond issue are contained in both §1.103-8(a)(5) and §1.150-2. Both rules were designed to limit the amount of proceeds that may be used, directly or indirectly, to finance working capital or to refinance a facility. The Temporary Regulations and the Final Regulations attempted to better coordinate these two reimbursement requirements by amending §1.103-8(a)(5) to include a reference to qualifying declarations of official intent (determined under §1.150-2). A limitation on the financing of working capital through the issuance of bonds to refinance a facility built or acquired before the issue date of the bonds is also contained in §1.103-8T(a)(5). For this reason, §1.103-8T(a)(5)(i) contains a general rule prohibiting financings where the same person was a substantial user of a facility both before and after the issue date (or the acquisition date). The Temporary Regulations also contain rules intended to prevent avoidance of this limitation through the use of related parties. These rules were not, however, intended to prohibit the financing of an acquisition of existing property from a person with whom the acquirer had no relationship prior to the acquisition.

Specific timing rules are provided in §1.150-2 which must be met if the proceeds of an issue of tax-exempt bonds are to be considered expended when advanced to reimburse a borrower or an issuer for expenditures previously paid or incurred. Such rules are measured by reference to the date an expenditure is paid or the placed in service date of a facility financed with proceeds of an issue rather than by reference to the issue date of an issue of bonds. The exception for acquisitions in §1.103-8T(a)(5)(i)(B) of the Temporary Regulations is consistent with the language in §1.150-2, but the general rule in the Temporary Regulations is inconsistent with both §1.150-2 and the exception for acquisitions in that it uses the issue date as the 5-year cut-off, thereby including, as prohibited transactions, those that triggered a relationship among the parties effective after the acquisition date but before the issue date.

Built-in protections in regard to bonding for facilities with respect to which relationships arise by virtue of the form of an acquisition include the $10 million and $40 million caps as well as the state volume cap applicable to most

private activity bond transactions. The Final Regulations will not affect the volume of tax-exempt financing in the United States in any material way.

Suggested Regulatory Language

We recommend that §1.103-8(a)(5)(i) be modified to read as follows (suggested changes shown in bold):

(i) A facility qualifies under section 1.103-8 only to the extent that there is a valid reimbursement allocation under section 1.150-2 with respect to expenditures that are incurred before the issue date of the bonds to provide the facility and that are to be paid with the proceeds of the issue. In addition, if the original use of the facility begins before the issue date of the bonds, the facility does not qualify under §1.103-8 if any person that was a substantial user of the facility **or a related person to that user** at any time during the 5-year period before the issue date **or, in the case of an acquisition, the acquisition date,** receives (directly or indirectly) 5 percent or more of the proceeds of the issue for the user's interest in the facility, and is a substantial user of the facility at any time during the 5-year period after **such issue or acquisition** date, unless--

§1.148-1(b) - Purchase Restrictions on Program Investments

A program investment, a type of purpose investment, may yield up to one and one half percentage points above the applicable bond yield (as compared to one eighth of one percentage point for most other purpose investments). One restriction on program investments under §1.148-1(b) is that the program documents prohibit the conduit borrower from purchasing tax-exempt bonds in an amount related to the amount of the applicable purpose investment (the "Purchase Restriction").

The Purchase Restriction hinders certain legitimate transactions. For example, to save costs, certain variable rate multifamily transactions are structured with the conduit borrower providing liquidity support either directly or through a reimbursement agreement; this transaction would not satisfy the Purchase Restriction. There appears to be no policy reason supporting the Purchase Restriction for this type of transaction.

Suggested Regulatory Changes

Delete item (4) of the definition of "Program Investment" in §1.148-1(b), at least for liquidity facilities provided by conduit borrowers.

§1.148-4(h)(2)(ii) provides that a qualified hedge must be entered into "between the issuer or the political subdivision on behalf of which the issuer issues the bonds. . .". Thus, the express language of the Final Regulations permits conduit borrowers to enter into qualified hedges. Unfortunately, there currently is no provision in the Final Regulations that allows the actual issuer to determine the yield on the program investment taking into account the hedge. The Final Regulations should clarify that when the conduit borrower enters into a qualified hedge, the actual issuer must include payments made or received on that hedge in determining the yield on the program investment.

§1.148-2(e)(3) or (2) - Temporary Period for Extraordinary Working Capital Expenditures

We believe that, as a result of a clear technical glitch caused by the addition of new definitions for restricted working capital expenditures and capital projects in going from the November 1992 arbitrage regulations to the Final Regulations which failed to encompass extraordinary working capital expenditures described in §1.148-6(d)(3)(ii)(B), extraordinary working capital expenditures seem to have fallen through the cracks for temporary period purposes beyond the residual 30 day temporary period. By way of brief background, §1.148-2(e)(3) of the November 1992 proposed arbitrage regulations proposed a 13 month temporary period for all working capital expenditures, including extraordinary working capital expenditures. §1.148-2(e)(3) of the Final Regulations instead provided a 13 month temporary period for newly defined restricted working capital expenditures, which included those subject to the bond proceeds spent last accounting rule under §1.148-6(d)(3)(i). In addition, §1.148-2(e)(2) of the Final Regulations provided a 3 year temporary period for newly defined capital project, which included working capital expenditures eligible for the exception to the bond proceeds spent last rule under §1.148-6(d)(3)(ii)(A) (*e.g.*, issuance costs). The Final Regulations failed to provide any specific temporary

period for extraordinary working capital expenditures described in §1.148-6(d)(3)(ii)(B). This appears to be unintended and without tax policy basis. If anything, tax policy would seem to support a longer temporary period for extraordinary working capital expenditures than for restricted working capital expenditures.

Suggested Regulatory Changes

We recommend that §1.148-2(e)(3) of the Final Regulations be expanded to provide a 13 month temporary period for all working capital expenditures, thus including both restricted working capital expenditures and extraordinary working capital expenditures. We further recommend that consideration be given to providing a 3 year temporary period for extraordinary working capital expenditures.

§1.148-2(f)(2)(ii) - Reserve Funds for Variable Yield Issues

We request clarification regarding the amount of gross proceeds of a variable yield issue that qualifies as a reasonably required reserve or replacement fund. §1.148-2(f)(2)(ii) provides that such a fund "may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue." Because the "interest requirements" on a variable yield issue are unpredictable, there is uncertainty in determining the permitted size of a reasonably required reserve or replacement fund.

Suggested Regulatory Changes

For the purpose of determining the permitted amount of a reasonably required reserve or replacement fund for a variable yield issue, the maximum interest rate permitted by the legal documents for the variable yield issue should be assumed as the proper rate in applying the term "interest requirements" in §1.148-2(f)(2)(ii). Rebate eliminates any advantage to purposely over-sizing a reserve fund under these circumstances. In this regard we suggest that a new sentence be added after the first sentence of §1.148-2(f)(2)(ii) to read as follows:

For purposes of the preceding sentence, the interest requirements of a variable yield issue may be based upon the maximum permitted interest rate for that issue.

§1.148-4T - Yield on an Issue of Bonds, Hedging Rules

In general, the new anticipatory hedge provisions contained in §1.148-4T are not well coordinated with the existing general eligibility requirements for qualified hedges. Our comments on §1.148-4T primarily make recommendations on how to clarify the extent to which the new anticipatory hedge provisions under §1.148-4T(h)(5) modify the general qualified hedge definition under §1.148-4(h)(2) for anticipatory hedges. Although, in our judgment, the issues discussed in this section generally do not raise major substantive or tax policy considerations, nonetheless they do create unnecessary ambiguity and warrant clarification in the Final Regulations.

The phrase "[f]or a contract to be a qualified hedge under §1.148-4(h)(2)" was added by §§1.148-4T(h)(2)(vii) and (ix) of the Temporary Regulations. Presumably this phrase was intended to acknowledge the special modifications of those provisions for anticipatory hedges. The phrase itself, however, is redundant since §1.148-4T(h)(1) only provides integrated hedge treatment for those hedges, including anticipatory hedges, that meet the qualified hedge definition under §1.148-4(h)(2). §1.148-4T(h)(5) only purports to modify certain eligibility requirements for anticipatory hedges within the overall context of the qualified hedge definition under §1.148-4(h)(2).

In addition, the Temporary Regulations are inconsistent and incomplete in their failure to include cross-references within other general eligibility provisions of the qualified hedge definition under §1.148-4(h)(2) for certain special modifications for anticipatory hedges which either: (1) are expressly cited in §1.148-4T(h)(5); or (2) reasonably should be modified expressly for anticipatory hedges. In this regard, §1.148-4T(h)(2) of the Temporary Regulations fails to include any cross-references to certain other provisions of the general qualified hedge definition which §1.148T-4(h)(5) expressly modifies for anticipatory hedges, including §1.148-4(h)(2)((i)(A) on the hedge definition and §1.148-

4(h)(2)(vi) on receipts by an issuer. In addition, our comments identify certain other general eligibility provisions of the qualified hedge definition which should be modified for anticipatory hedges.

Suggested Regulatory Changes

<u>§1.148-4(b)(3) and §1.148-4T(g)</u>. The relation is unclear between §1.148-4(b)(3) which imposes some special yield calculation rules to restrict potential yield distortions (*e.g.,* certain issues with large premium bonds or stepped coupon bonds) and the first sentence of §1.148-4T(g) which generally applies the Section 143(g)(2)(C)(ii) FHA mortgage prepayment assumptions in bond yield calculations on prescribed mortgage revenue bonds. Although it appears that §1.148-4(b)(3) was intended to override §1.148-4T(g) to the extent of the limited circumstances in which §1.148-4(b)(3) applies to restrict potential yield distortions, there is some uncertainty and difference of interpretation. We recommend clarification of the relation between these two special yield calculation rules.

<u>§1.148-4T(g)</u>. We do not believe that it is appropriate that the yield on variable rate student loan bonds for rebate purposes be calculated over the term of the issue. Variable rate student loan bonds are common. There is no reason that the arbitrage rebate for these rules should be calculated in a different manner than the "snapshot" approach used for other variable yield issues. The current rule adds needless complication to the rebate calculations for these issues.

<u>§1.148-4(h)(2)</u>. We recommend that the relationship between the general eligibility requirements for qualified hedges and the special modifications for anticipatory hedges be clarified through a single overriding cross-reference in the lead-in phrase in §1.148-4(h)(2) to the following effect (suggested changes are in bold):

> "**Except to the extent that paragraph (h)(5) of this section modifies the general eligibility requirements of this paragraph (h)(2) for anticipatory hedges expressly or by reasonable**

implication, a qualified hedge is a contract that satisfies each of the following requirements:

We believe that this overriding cross-reference would generally clarify this issue. This should eliminate the need to make express reference to anticipatory hedge refinements in the various general eligibility provisions. In addition, although not essential, if this cross-reference were to include the suggested phrase" by reasonable implication," it would eliminate the need to assure that §1.148-4T(h)(5) cited every provision of §1.148-4(h)(2) that appropriately needs to be modified in some way to accommodate anticipatory hedges.

In addition, the following sections discuss several specific general hedge eligibility provisions on which modifications may be needed for anticipatory hedges, depending on the breadth of any general overriding cross-reference to §1.148-4T(h)(5) in §1.148-4(h)(2).

§1.148-4(h)(2)(i)(A). Consider adding the phrase "or anticipated borrowing" at the end of the first sentence in §1.148-4(h)(2)(i)(A) relating to the definition of a hedge.

In addition, more generally, the Service should consider clarifying whether a swap from a fixed rate to a floating rate is a hedge. The issue in this type of transaction is whether a swap from a fixed rate to a floating or variable rate is "entered into primarily to reduce the issuer's risk of interest rate changes with respect to a borrowing" as set forth in §1.148-4(h)(2)(i)(A).

In this regard, we note that virtually identical language in Section 1256(e) on which the arbitrage definition of a hedge was based, has been interpreted on a long-standing basis to include fixed-to-floating interest rate swaps within the definition of hedges for general business tax purposes. In addition, §1.1221-2(c)(1)(ii)(B) of the final general business hedging regulations specifically treats at least certain fixed-to-floating interest rate swaps as hedges (*e.g.,* certain such swaps used to reduce interest rate risk associated with the spread between a taxpayer's fixed rate debt and floating rate assets), but leaves some uncertainty. We believe that it is especially important to provide guidance to establish greater certainty in the arbitrage area regarding whether or the extent to which fixed-to-floating interest rate swaps properly constitute hedges for arbitrage purposes.

Although some believe that the better approach would be to treat all fixed-to-floating swaps as hedges for arbitrage purposes, it is far more important to provide a more certain answer, one way or the other, to enhance consistent treatment. Otherwise, undue potential for alternative answers and possible abuse may persist.

<u>§1.148-4(h)(2)(i)(B)</u>. The third sentence of §1.148-4(h)(2)(i)(B) provides that a contract may contain a significant investment element "if payments under the contract do not correspond closely in time and amount to the interest payments on the bonds being hedged." The mere payment or a receipt on an anticipatory hedge before the issue date alone should not cause the anticipatory hedge to contain a significant investment element.

<u>§1.148-4(h)(2)(vi) and (viii)</u>. Under §1.148-4(h)(2)(vi) payments to the issuer under the hedge must correspond closely, in both time and amount, to the specific interest payments being hedged on the hedged bonds. §1.148-4T(h)(2)(vii) provides generally that payments (presumably to or from an issuer) must not begin to accrue earlier than the issue date of the hedged bonds. §1.148-4T(h)(5)(ii)(B) provides that a payment to terminate an anticipatory hedge does not prevent a hedge from satisfying §1.148-4(h)(2)(vi) on payments to the issuer or §1.148-4T(h)(2)(vii). Although a one-time cash settlement payment to terminate an anticipatory hedge on a bond issue date may be one common payment method for these hedges, this provision inaccurately seems to contemplate that all anticipatory hedges are bought, paid for, and settled in that manner. Except for the expressly-referenced termination payments, the treatment of payments made by an issuer to purchase (rather than terminate) an anticipatory hedge and the treatment of any payments accruing on an anticipatory hedge during its term before the issue date of the hedged bonds (other than termination payments) is unclear.

We recommend that a payment made by an issuer to purchase an anticipatory hedge or and any payments (to or from an issuer) that accrue on an anticipatory hedge on or before the issue date of the hedged bonds should not disqualify an anticipatory hedge under §1.148-4(h)(2)(vi), (vii), or otherwise. §1.148-4T(h)(5)(ii)(C) suggests that this is the correct result with its recognition that a fixed yield bond can result from the use of an anticipatory hedge "taking

into account payments on the hedge that are made or fixed on or before the issue date." We recommend express clarification of this point in §1.148-4T(h)(5)(ii)((B).

<u>§1.148-4(h)(2)(viii)</u>. We recommend that you consider clarifying that an issuer's use of bond proceeds to make an anticipatory hedge termination payment does not fail the same source of payments principle under §1.148-4(h)(2)(viii). This would seem similar to an issuer's use of bond proceeds to pay capitalized interest.

<u>§1.148-4T(h)(3)(iii)</u>. §1.148-4T(h)(3)(iii) provides, in relevant part, that the period to which a hedge payment relates is determined under general Federal income tax principles, including, without limitation, §1.446-3. §1.446-3 in turn provides general Federal income tax accounting timing rules for notional principal contracts. The accounting timing rules on notional principal contracts became final on October 3, 1993. The Final Regulations included a more generic version of a citation to those rules, specifically section 446 and regulations thereunder on notional principal contracts, presumably because those rules were thought to provide some likely relevant accounting timing principles and were well in progress at the time. In addition, equally important, closely related, and arguably more relevant general Federal tax rules on accounting timing rules in many circumstances regarding hedges were finalized under §446 and §1.446-4 on July 18, 1994, after the Temporary Regulations were issued.

In order, presumably, to coordinate with, and not override, the specific arbitrage hedging rules for yield computation purposes, §1.446-4(a)(2)(iii) provides that §1.446-4 does not apply to the determination of the issuers yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions to which §1.148-4(h) applies. Still, §1.446-4 includes various accounting timing rules for hedges that properly ought to be considered for arbitrage purposes. The existing inclusion of a cross reference to the notional principal contract timing rules and the failure to include a similar cross-reference to the at least equally relevant general hedging accounting timing rules presents ambiguity on the proper arbitrage accounting for certain hedges.

We recommend that the first sentence of §1.148-4T(h)(3)(iii) be amended to include the phrase "and §1.446-4" immediately after the phrase "§1.446-3."

Alternatively, both of those cross references could be deleted and the relevant principle could be left as general Federal income tax principles.

§1.148-4T(h)(5)(ii). Depending on the approach taken to an overriding cross-reference to §1.148-4T(h)(5)(ii), we recommend that you consider making express reference in this section to each of the above-referenced general eligibility provisions which are modified to some extent for anticipatory hedges. These referenced sections include subsections (i)(A), (i)(B), (vi), (vii), (viii), and (ix) of §§1.148-4(h)(2) or 1.148-4T(h)(2).

In addition, the last sentence in §1.148-4T(h)(5)(ii)(B) provides that termination payments received by an issuer on an anticipatory hedge are bond proceeds. We recommend that this provision be expanded to recognize that termination payments on an anticipatory hedge can go either to or from an issuer, and that, in either event, they should be taken into account appropriately as an adjustment to the yield on the hedged bonds.

§1.148-4(b)(1) and §1.148-4(c)(1). One general technical issue is how to properly account for any payments or receipts on an anticipatory hedge that arise before the issue date of the hedged bonds for arbitrage yield purposes. We recommend that you consider providing express guidance on this point. In related provisions, §§1.148-4(b)(1) and (c)(1) on arbitrage bond yield computations for fixed yield issues and variable yield issues, respectively, each incorporate a notion of the "present value" of the "issue price" as of the issue date for fixed yield issues or as of the first day of the computation period for variable yield issues. The more typical circumstance contemplated was the case in which not all bonds that are part of a single issue are issued on the same date.

It would seem that, for pre-issue date payments or receipts on an anticipatory hedge, an appropriate way to account for those payments for arbitrage yield purposes would be to future value those payments or receipts at the expected bond yield to the issue date of the hedged bonds. In addition, it would further seem appropriate to use the yield on the hedged bonds, determined either with regard to the anticipatory hedge payments, or perhaps for ease of computation similar to the safe harbor method for certain hedge termination payments under §1.148-4(h)(3)(iv)(E), without regard to the pre-issue

date payments or receipts on an anticipatory hedge, as the discount rate in future valuing those payments to the issue date of the hedged bonds.

One the other hand, however, while it seems appropriate to factor pre-issue date payments or receipts on an anticipatory hedge into the arbitrage yield calculation, it would seem entirely inappropriate to somehow treat those payments as bond proceeds for arbitrage restriction purposes before any tax-exempt bonds are issued. That point also should be made clear.

One further point, illustrated by the following example, warrants clarification. If an anticipatory fixed rate hedge is entered into in connection with a future issue of variable rate bonds, the treatment of payments or receipts with respect to that hedge and its termination should be specified in the event the hedge is terminated and the variable rate bonds are not issued. (A likely scenario is that a fixed rate bond issue is issued on or about the date on which the variable rate bonds were to have been issued. We believe that the anticipatory hedge payments and receipts properly should be taken into account with respect to the fixed rate bonds. Any such clarification should consider the existing structure of the Final Regulations, including the allocation of termination payments under §1.148-4(h)(3)(iv) to the periods to which the hedge relates, as well as whether the refinancing is separated by a substantial period of time from the termination of the anticipatory hedge.

§1.148-4(b)(3)(ii)(A) - Five-Year Optional Redemption Rule

The yield on a fixed yield issue is computed pursuant to the rules contained in §1.148-4(b). Special rules relating to bonds subject to early redemption are contained in subparagraph (3) of that section. The general rule, in §1.148-4(b)(3)(i), provides that if the fixed yield bond is subject to optional early redemption and is described in paragraph (b)(3)(ii), then the yield on the issue containing the bond is computed by treating the bond as redeemed at its stated redemption price on the optional redemption date that would produce the lowest yield on the issue. "Stated redemption price," under the definitions in §1.148-1(b), includes any redemption premium.

Where an issue consists in part of bonds subject to optional redemption within five years of their issue date, even if none of the bonds of the issue is issued at a premium, the test in subdivision (A) of subdivision (ii) must be applied to determine whether the bonds are "described in paragraph (b)(3)(ii)." The notion is that, with respect to a bond issue that is structured with serial bonds and term bonds along the tax-exempt yield curve, the yield resulting from the early redemption of the bond issue will be lower than the issue's yield-to-maturity. The test thus compares the yield on the bond issue computed by assuming all bonds of the issue subject to optional redemption within five years of the issue date are redeemed at maturity to the yield on the bond issue computed by assuming all bonds of the issue subject to optional redemption within five years of the issue date are redeemed on their earliest optional redemption date. If the former exceeds the latter by more than one-eighth of one percentage point, the bond is described in paragraph (b)(3)(ii), and the optional redemption date that produces the lowest yield on the bond issue must be used to compute the issue's yield.

Clarifying language is needed in one respect. One could arguably read the test comparing the issue's yield-to-maturity and its yield-to-call as excluding the redemption premium from the yield-to-call calculation, solely because of the absence of the language "at its stated redemption price," which is present in the general rule of §1.148-4(b)(3)(i) for purposes of calculating the yield on the bond issue once a bond is determined to be described in paragraph (b)(3)(ii). Although we believe most practitioners have not adopted that approach because of its potentially anomalous results, the omission of such language makes the provision susceptible to a dual reading. Since the concept is that once the one-eighth spread is exceeded, the lower yield-to-call will be used, inclusive of any redemption premium, it makes little sense to apply the test excluding the redemption premium. Otherwise, one could conceivably encounter a situation where the one-eighth spread is exceeded by ignoring the redemption premium, but the yield on the bond issue, calculated by treating bonds subject to early optional redemption as redeemed at their stated redemption price (i.e., with redemption premium) on their optional redemption date that produces the lowest yield on the bond issue, is actually higher than the issue's yield-to-maturity.

Suggested Regulatory Changes

The following change (shown in bold) is recommended:

In §1.148-4(b)(3)(ii)(A), delete the phrase "by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption" and insert in its place "**by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at their stated redemption prices at the earliest date for their redemption**".

§1.148-5(b)(2)(iii) - Fair Market Valuation Rules

A problem exists in the interplay between the universal cap allocation rule and the fair market value rule as applied to defeasance escrows funded with other than proceeds of tax-exempt bonds. While this particular problem may be attributed to the amendment by §1.148-5T(d)(3)(ii) of the Temporary Regulations, it is representative of the larger problem associated with the limitation on the ability to treat all yield restricted nonpurpose investments as a single investment for both purposes of yield limitation and rebate. In this regard, §1.148-5T(b)(2)(iii) of the Temporary Regulations limit of such treatment to a sinking fund established as of the issue date is overly restrictive.

The problem may best be understood by way of an example. One context in which the problem occurs is a "change in use" situation resulting in "disposition proceeds" funding a defeasance escrow for an outstanding issue of advance refunding bonds which refinanced the original facility the subject of the change in use. To the extent that the value of the refunding bonds exceeds the value of the escrow funded with refunding bond proceeds (referred to as the "refunding escrow" as distinguished from the "defeasance escrow" funded with disposition proceeds), the defeasance escrow will be allocated to the refunding issue as replacement proceeds. However, by application of the universal cap, a portion of the defeasance escrow is likely not to be immediately allocated to the refunding issue, as it is possible for the value of the refunding escrow plus the defeasance escrow to exceed the value of the refunding bonds. As the value of the refunding escrow reduces (that is, as the refunding escrow pays debt service on the issue which it refunded), portions of the defeasance escrow will become

allocated to the refunding issue. The problem is in valuing the investments in the defeasance escrow at their fair market value on the date that they are first allocated to the refunding issue (*see* §1.148-5(d)(3)(i)). Because the value of the defeasance escrow will most certainly change over time and the valuation of the investments within the defeasance escrow is made as of the date on which they are allocated, the yield on such investments when allocated to the refunding issue cannot be determined at the time the defeasance escrow is established. Even though the defeasance escrow may be initially invested at a yield not in excess of the yield on the refunding issue, if the fair market value of the investments in the defeasance escrow has decreased over time, they may have a yield in excess of the yield on the refunding issue when first allocated by operation of the universal cap.

Prior to the Temporary Regulations, §1.148-5(d)(3)(ii) provided an exception from the fair market value rule to allocations or de-allocations resulting from the application of the universal cap. However, even this prior provision assumed that the amounts were initially allocated to an issue and then ceased to be allocated as a result of the universal cap rule. In the above example, the amounts are not initially allocated to any issue because of the universal cap, and only become allocated over time. The Temporary Regulations exacerbate this problem by adding the additional restriction that the amounts must have been allocated to an issue of tax-exempt bonds, which adds a complicating factor but does not resolve the problem.

Our recommended solution to this problem is to provide that the mandatory valuation of investments at fair market value rule of §1.148-5(d)(3)(i) should be applied to an investment on the first date that it would be allocated to an issue without regard to the application of the universal cap. In the example identified above, this would allow the defeasance escrow to be valued at its fair market value on the date it is first established and there would be no requirement that it be revalued as a result of any allocation or de-allocation by operation of the universal cap.

This problem is representative of the difficulties which arise as a result of not allowing all yield-restricted nonpurpose investments to be treated as a single investment for yield investment and rebate purposes. In the example described

above, the refunding escrow and the defeasance escrow are treated as a single investment having a single yield for purposes of the yield restriction rules of Section 148(a) of the Code and §1.148-2 but are not treated as a single investment for purposes of the arbitrage rebate requirements of Section 148(f) of the Code and §1.148-3. Further, while the individual investments in the refunding escrow may be treated as a single investment for all purposes of Section 148 of the Code, each separate investment in the defeasance escrow must be independently valued for purposes of the arbitrage rebate requirements. This inconsistency of treatment between the yield restriction rules and the rebate rules, together with the annual application of the universal cap resulting in a revaluation of investments within the defeasance escrow when such amounts are allocated or de-allocated, can lead to some odd results.

Assume that on or before an installment computation date for arbitrage rebate purposes, all or a portion of the defeasance escrow has either become allocated or ceases to be allocated to the refunding issue, with the result that it is valued at its fair market value. This allocation or de-allocation can result in an arbitrage rebate payment being required even though the yield on the defeasance escrow did not initially exceed the yield on the refunding bonds and no investments within the defeasance escrow were purchased or sold. For purposes of the yield restriction rules, the de-allocation at then fair market value will also result in the single class of investments (including the defeasance escrow and the refunding escrow) having a yield which may change (either up or down) as a result of such valuation. The possibility that a rebate payment would be required in these circumstances, or that the investments have a "variable yield" is not a proper result, either economically, practically or from a public policy perspective. We also note that, in general, investments are not required to be marked-to-market under the Code when held by the same investor regardless of the account in which it is held. The simple solution is to return to the prior rule which allowed replacement proceeds in a defeasance escrow and proceeds in a refunding escrow to be blended as a single class of investments for both yield restrictions and rebate purposes.

Suggested Regulatory Language

With respect to the issues described above, we suggest the following changes (shown in bold) be made:

> **§1.148-5(d)(3)(i).** Modify this section by changing the first sentence to read as follows (the suggested change being in bold) - "Except as provided in paragraphs (d)(2), (d)(3)(ii), and (d)(4) of this section, an investment must be valued at fair market value on the date that it is first allocated **(or would be allocated but for the application of the universal cap under §1.148-6(b)(2))** to **a tax-exempt** issue or first ceases to be allocated to **a tax-exempt** issue as a consequence of a deemed acquisition or deemed disposition.

§1.148-5(c) - Yield Reduction Payments

The provisions of §1.148-5(c) of the Final Regulations permitting yield reduction payments as a method of complying with yield restriction requirements have proven to be a very effective and efficient. It is our understanding that yield reduction payments were not made available to all types of yield restricted proceeds because of a concern that arbitrage abuse may result. We believe that the use of yield reduction payments since the inception of the concept has shown that this method of yield restriction compliance provides no reasonable opportunity for arbitrage abuse. To the contrary, yield reduction payments provide an efficient yield restriction method especially when the restricted proceeds are also subject to rebate. Therefore, we ask that you consider extending yield reduction payments to all gross proceeds. This could be accomplished by simply deleting §1.148-5(c)(3) in its entirety. In the alternative, if you determine not to extend yield reduction payments to all proceeds, we ask that you extend yield reduction payments to variable rate advance refunding bonds. This change could be accomplished by adding new subparagraph (3) to §1.148-5(c)(3)(i)(C) to read as follows:

> **(3) An advance refunding issue that is a variable yield issue.**

§1.148-9(c)(2)(ii)(A) - Treatment of Beginning Cash in Mixed Escrows

Refunding escrows are often initially funded with cash as well as investments. The cash, generally referenced as "beginning cash" is ordinarily required for payment of debt service due on the refunded bonds before the maturity of the earliest maturing investments or is required for rounding purposes so as to assure escrow sufficiency. Beginning cash often represents amounts that were held in a bona fide debt service fund for the prior issue or, occasionally, amounts held in a fund to carry out the governmental purposes of the prior issue.

§1.148-9(c)(2)(ii)(A) requires that amounts previously held in a bona fide debt service fund or a fund to carry out the governmental purposes of the prior issue be allocated to the earliest maturing investments in a mixed escrow. We believe this rule should be slightly expanded to permit such amounts also to be allocated to beginning cash in a mixed escrow.

Suggested Regulatory Changes

We suggest that the last phrase of the last sentence of §1.148-9(c)(2)(ii)(A) be modified by adding the language (shown in bold) set forth below:

> . . . those amounts must be allocated to the earliest maturing investments in the mixed escrow **or to cash in the mixed escrow to be spent for principal, interest or stated redemption prices on the prior issue, or both.**

§1.148-10(c) - Excess Proceeds and Capitalized Interest

The definition of excess gross proceeds in §1.148-10(c) includes interest paid on a refunding issue subsequent to the completion date of the project plus one year. However, under §1.148-6, new money transactions can be sized to include interest ending on the later of three years from the issue date or one year after the date in which the project is placed in service. These two provisions should be consistent.

Suggested Regulatory Changes

Amend §1.148-10(c)(2)(ii) to be consistent with §1.148-6 with respect to the sizing of capitalized interest (change shown in bold) by deleting the remainder of the clause after "for a period" and by inserting **"ending on the date that is the later of three years from the issue date of the applicable new money prior issue or one year after the date on which the project is placed in service"** after the words "for a period" in §1.148-10(c)(2)(ii).

§1.149(d)-1(d)(2) - Application of Mixed Escrow Rules to Section 149(d) of the Code

§149(d) contains restrictions relating to the issuance of advance refunding bonds. Among such restrictions, in §149(d)(3)(A)(ii) and (iii), is a requirement that (A) refunded bonds issued before 1986 be redeemed no later than the earliest date on which such bonds may be redeemed at par or at a premium of three percent or less, and (B) refunded bonds issued after 1985 be redeemed no later than the earliest date on which such bonds may be redeemed (without regard to the existence or amount of any redemption premium).

The "mixed escrow" rules, contained in §1.148-9(c)(2), are a set of rules that govern the allocation of moneys from different sources deposited in an escrow to pay the principal of and/or interest on a prior issue. For example, certain types of moneys must be allocated to the earliest maturing investments in the escrow. Other types of moneys may be allocated to longer investments so long as the expenditure of bond proceeds does not occur faster than ratably with the expenditure of the other moneys (certain unexpended proceeds of the prior issue must be ratable with bond proceeds). The primary purpose of these rules is to prevent possible abuses, in some cases involving the "flip-flopping" of funds, that achieve a yield or arbitrage advantage.

In cases where an issuer contributes its own equity to a transaction involving the advance refunding of a prior bond issue, perhaps because it wishes (for whatever reason) to defease bonds of the prior issue that are not permitted to be advance refunded, and allocates the equity to the non-advance-refundable bonds, such allocation would appear to conflict with the mixed escrow rules of

§1.148-9(c)(2). For example, if the non-advance-refundable bonds are the longer bonds of the prior issue, the mixed escrow rules would reallocate the bond proceeds and equity, for purposes of yield compliance under §148, as purchasing the escrow investments ratably. If such reallocation were then analyzed under §149(d), bond proceeds would be allocated to the payment of debt service on non-advance-refundable bonds, resulting in a prohibited advance refunding.

§1.149(d)-1(d)(2) resolves this problem by providing that, for certain purposes of §149(d), the mixed escrow rules do not apply to "amounts that were not gross proceeds of the prior issue before the issue date of the refunding issue." This solution avoids the allocation of bond proceeds to non-advance-refundable bonds by indicating that, for certain purposes of §149(d), the issuer's allocation of bond proceeds and equity will be respected. Conversely, the application of the mixed escrow rules cannot be avoided as to prior trustee-held funds (which, unlike equity, are gross proceeds of the prior issue before the date of the refunding issue). This prevents an issuer, for example, from using unexpended construction funds from the prior bond issue to defease otherwise non-advance-refundable bonds. The scope of the rule thus is sensible.

The rule has a glitch, however. §1.149(d)-1(d)(2) provides that the mixed escrow rules do not apply, when the allocation of equity is involved, for three purposes: (1) Section 149(d)(2), prohibiting the advance refunding of private activity bonds, (2) Section 149(d)(3)(A)(i), limiting the advance refunding of governmental and 501(c)(3) bonds to once or twice, depending on when the original (new money) bonds were issued (post-1985 or pre-1986), and (3) Section 149(d)(3)(A)(ii), requiring that pre-1986 bonds be redeemed no later than their earliest optional redemption date so long as any redemption premium is no greater than three percent. The requirement of Section 149(d)(3)(A)(iii) that post-1985 bonds be redeemed on their earliest optional redemption date, however, is not excluded from the application of the mixed escrow rules, so that an issuer that uses its own equity to effect a defeasance of non-advance-refundable post-1985 bonds may be required to redeem such bonds on their first optional redemption date, even if it is uneconomic to do so. There seems to be no valid reason to distinguish for this purpose between pre-1986 and post-1985 bonds. Further, for purposes of Section 149(d)(3)(A)(i), which limits the number of advance refundings, no such distinction has been made. The omission of a

reference to clause (iii) of Section 149(d)(3)(A) therefore appears to be an oversight.

Suggested Regulatory Changes

The following change (shown in bold) is recommended:

In §1.149(d)-1(d)(2), delete the phrase "for purposes of section 149(d)(2) and (d)(3)(A)(i) and (ii)" and insert in its place "**for purposes of section 149(d)(2) and (d)(3)(A)(i), (ii) and (iii)**".

§1.148-1(b) - Proposed Regulations, Definition of Investment-type Property

Investment-type Property is currently defined in §1.148-1(b) (as amended by T.D. 8476), for purposes of determining whether governmental obligations are "arbitrage bonds" as follows:

> ...Investment-type property also includes a contract that would be a hedge (within the meaning of §1.148-4(h) except that it contains a significant investment element....

The Proposed Regulations would delete the definition of investment-type property in §1.148-1(b) and would add a new definition of investment-type property in §1.148-1(e). In this new definition, §1.148-1(e)(3) would provide the following:

> An interest rate cap contains a significant investment element if the payments for the cap are made more quickly than in level annual installments over the term of the cap or the cap hedges a bond that is not a variable rate debt instrument under §1.1275-5. In addition, a cap generally contains a significant investment element if the cap rate is less than the on-market swap rate on the date the cap is entered into. [Effective date material omitted.]

The treatment by the Proposed Regulations as investment-type property of any interest rate cap where payments are made more quickly than in level

annual installments over the term of the cap is flawed. An interest rate cap contract is not inherently an investment. Depending upon the specific cap (or strike) rate relative to current and projected market interest rates, the cap may or may not have an expected investment return. Without an expectation of any return, it would seem difficult to conclude that any arrangement is an investment. In this case, caps would be no different from, say, a casualty insurance policy, where the insured has no specific expectation of loss but as a matter of prudence protects itself against the possibility of loss. No one would contend that the insurance policy and the premium paid for it constitute an investment. Similarly, a cap without an expected investment return should not be treated as an investment.

A related but distinct point is that a cap that is a qualified hedge, as with the casualty insurance policy, has no real "payoff." Any receipt on the cap merely compensates for a corresponding expense on the bonds. If an issuer were merely speculating on interest rates (of doubtful legality in most jurisdictions), the result might be different; in that case, however, if the issuer did not use bond proceeds to purchase the cap it would not be allocable to the bonds in any event.

Another and currently popular way to express the same concept is bifurcation. As with other hybrid financial instruments, a cap could be deconstructed into discrete elements that reflect an investment component and a pure hedge component. Assuming that a good methodology is adopted to determine that a particular cap has no investment component, the cap should be treated entirely as a pure hedge.

Once it is established that a particular cap has no expected return or investment element, the focus would be entirely on the up front payment itself. It is very common for interest rate caps to be paid in full at the inception of the contract. Accordingly, they fit squarely within the exception for investment-type property in §1.148-1(b) in that "prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing." There is no reason to deviate from this standard where the subject matter of the payment (the cap contract) is not otherwise an investment.

Suggested Regulatory Changes

We do not advocate a de minimis approach to the issue of up-front payments for a cap, primarily for conceptual reasons. On the one hand, if the use of bond proceeds to purchase an interest rate cap is otherwise a legitimate expenditure of bond proceeds, there seems to be no basis to arbitrarily limit the amount that can be so spent. On the other hand, if it were somehow clear that caps constituted investment property (or that the mere prepayment of them constituted investment-type property), we are not aware of any de minimis rule for arbitrage other than the $100,000 minor portion. If, notwithstanding that, the Treasury decides to adopt a de minimis rule, it is our experience that 1% of the issue price would cover the majority of cap hedging transactions that have been entered into and 2% would cover virtually all of them.

Requiring pay-as-you go caps will reduce the financing flexibility of many issuers. Many major cities, some states, and numerous local districts have poor credit ratings. An up-front payment for a cap, besides being standard practice, eliminates credit risk to the cap provider. A pay-as-you go requirement would, at the very least, make caps more expensive to poorer credits and at worst make them wholly unavailable to others.

§1.148-1(e) - Proposed Regulations, Reference to VRDIs and On Market Swaps

In determining whether a hedge contains a significant investment element, §1.148-1(e)(3) of the Proposed Regulations states that an interest rate cap contains a significant investment element if the cap hedges a bond that is not a variable rate debt instrument ("VRDI") under §1.1275-5. We believe that this restriction should be deleted. The Proposed Regulations suggest that if the hedged bond is not a VRDI, then the corresponding hedge cannot constitute a qualified hedge. Whether a hedged bond constitutes a qualified VRDI should be irrelevant in determining whether a cap (or other hedge) constitutes a hedge.

Tax counsel have assumed that the Proposed Regulations' reference to the VRDI regulations was intended to discourage the issuance of leveraged inverse floater bonds and embedded cap bonds where the multiplier exceeds 1.35. The

fact that a cap hedges a leveraged embedded cap bond (as opposed to an unleveraged embedded cap bond or plain floating rate bond) should not automatically result in classification of that cap as investment-type property. Moreover, the issue of excess leverage is moot because the final contingent debt regulations under §1.1275-4 thoroughly control this issue for non-VRDIs. From the issuer's standpoint, whether a cap is an investment or a hedge depends on whether the cap contains an expected return.

§1.148-1(e)(3) Proposed Regulations - On Market Caps

Under §1.148-1(e)(3) of the Proposed Regulations a cap generally contains a significant investment element if the cap rate is less than the on-market swap rate on the date the cap is entered into. We do not understand the purpose of this limitation. The Proposed Regulations apparently assume that if a cap's strike price is less than the on-market swap rate, then the cap premium contains an impermissible investment element (*i.e.,* the cap is somehow "off-market"). This assumption may be based on the fact that the cap fee increases (and the likelihood that a purchaser will receive payments under the cap increases) as the strike rate decreases.

Unlike the swap market, there is no "on-market" cap rate. Cap prices are based on statistical probabilities that a variable index will exceed a pre-determined fixed rate over a specified period of time. There is no reasonably expected return on a cap unless the strike rate is below the current index rate. Even these caps, however, can hedge an issuer's risk of interest rate changes. We understand the Treasury's concerns about potential abuses with hedges. For example, if the strike rate were zero, the cap resembles a debt obligation and should be treated as an investment. We are not aware of any cap transaction where the issuer attempted to integrate a cap with a strike rate that was below the current variable index. With the exception of this extreme example, caps should not be treated as investments. The increased likelihood of payment under the cap should not be confused with the expected return inherent in an investment. For these reasons, we believe that the reference to the on-market swap rate in the definition of investment-type property should be deleted.

We want to re-emphasize our comment made at the public hearing that guidance and certainty are sorely needed on how to treat hedges of assets or investments of tax-exempt bond proceeds for arbitrage purposes. Similar to the concern about fixed-to-floating interest rate swaps, the most important point here is to provide guidance to establish greater certainty. One possible approach would be a brief provision to the effect that asset hedges are taken into account in investment yield under principles similar to the arbitrage provisions on qualified hedges on the bond side. An alternative approach which would provide equal certainty and perhaps be simpler would be to disregard asset hedges entirely for arbitrage purposes.

Further Discussion of These Comments and the Temporary Regulations

We appreciate the IRS' and Treasury's consideration of these comments, and would be pleased to make ourselves available to discuss them should this be helpful. Questions should be directed to David A. Walton, chair of the Arbitrage and Rebate Committee, at (415) 391-5780.