Bond Case Briefs

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ABA Tax Section Suggests Changes to Proposed Arbitrage Restriction Regs.

Michael Hirschfeld of the American Bar Association Section of Taxation, in comments on proposed regulations (REG-148659-07) on the section 148 arbitrage investment restrictions applicable to tax-exempt bonds and other tax-advantaged bonds, has suggested changes to the rules on the allocation of tax-exempt bond proceeds to working capital expenditures.

The tax section believes the proposed regs adopt a reasonable approach for issuers and the IRS to determine definitively if bonds for working capital remain outstanding longer than necessary. While supporting the general framework of requiring periodic testing and an unburdening action, section members suggest modifying the proposed rules for longer-term working capital financings so that an issuer can test "available amounts" under reg. section 1.148-6(d)(3)(iii) as of a date other than the first day of a fiscal year. Pointing out that testing as of the first day of each fiscal year does not work well for most issuers because their fiscal year does not coincide with their cash flow needs, members propose three alternative methods to implement testing as of dates appropriate to the issuer.

The current regs allow bonds to be issued for some extraordinary noncapital expenditures such as large tort settlements but provide no guidance on how long those bonds may remain outstanding. The tax section recommends expanding the definition of extraordinary working capital and establishing a safe harbor based on weighted average maturity for longer-term extraordinary working capital financings.

While acknowledging that the proposed regs provide an appropriate framework for the treatment of tax-exempt bond proceeds allocated to grants, the tax section requests additional guidance on the treatment of grants. Section members also suggest clarifying the definition of available amount to exclude proceeds of any issue and providing examples to show why this is important.

January 30, 2014

Hon. John Koskinen

Commissioner

Internal Revenue Service

1111 Constitution Avenue, NW

Washington, DC 20024

Re: Comments Concerning Tax Exempt Working Capital Financing, Grants, and Qualified Hedges

Dear Commissioner Koskinen:

Enclosed are comments concerning tax exempt working capital financing, grants, and qualified hedges. These comments represent the view of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Michael Hirschfeld

Chair, Section of Taxation

American Bar Association

Washington, DC

Enclosure

cc:

Mark J. Mazur,

Assistant Secretary (Tax Policy),

Department of the Treasury

William J. Wilkins,

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Internal Revenue Service

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AMERICAN BAR ASSOCIATION SECTION OF TAXATION

COMMENTS ON PROPOSED REGULATIONS: TAX EXEMPT WORKING

CAPITAL FINANCING, GRANTS, AND QUALIFIED HEDGES

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments with respect to the portions on working capital financings and grants was exercised by David Cholst of the Committee on Tax-Exempt Financing (the "Committee"). Substantive contributions in this area were made by Irving G. Finkel, Charles C. Cardall, Carol L. Lew, Christie L. Martin and Mark O. Norell. Principal responsibility for preparing the portions of these Comments with respect to qualified hedges was exercised by George G. Wolf. Substantive contributions in this area were made by Arthur M. Miller, Mark O. Norell and John T. Lutz. The Comments were reviewed by Nancy M. Lashnits, Chair of the Committee, by Frederic L. Ballard, Jr., reviewer for the Section's Committee on Government Submissions, and by Bahar Schippel, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matters of these Comments.

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Date: January 30, 2014

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WORKING CAPITAL FINANCINGS AND GRANTS

EXECUTIVE SUMMARY

The Committee thanks the Internal Revenue Service (the "Service") and the Department of the Treasury ("Treasury") for endeavoring to provide helpful proposed regulations related to working capital. The Service and Treasury have shown that they understand the need of state and local governments to finance non-capital expenditures with bonds that have maturities in excess of two years. The Existing Regulations1 already have extensive rules relating to the allocation of tax-exempt bond proceeds to working capital (i.e., non-capital) expenditures. The Service, Treasury and practitioners, for the most part, appear to believe those rules work relatively well. The Committee agrees with this assessment. As stated below, the Service and Treasury addressed some deficiencies in those rules by making certain modest changes. The Committee suggests certain additional modest changes. Missing from the Existing Regulations is a relatively definitive way to determine if tax-exempt bonds issued for such purposes will be outstanding longer than necessary. When tax-exempt bonds are left outstanding longer than necessary, an arbitrage concern is raised. The Proposed Regulations2 adopt a reasonable approach for issuers and the Service to determine definitively if bonds for working capital remain outstanding longer than necessary.

No modifications are needed to the proposed changes in computing the reasonable working capital reserve or the length of temporary periods. Existing Regulations allow bonds to be issued for certain extraordinary non-capital expenditures (e.g., large tort settlements), but provide no guidance on how long such bonds may remain outstanding.

The Proposed Regulations provide an appropriate framework for allowing longer term tax-exempt bonds for working capital purposes. The general regime of requiring periodic testing and an unburdening action is a reasonable and workable approach. The Committee recommends, however, that the Service and Treasury modify the proposed rules for longer term working capital financings so that an issuer can test "available amounts"3 as of a date other than the first day of a fiscal year. Testing available amounts as of the first day of each fiscal year will not work for most issuers because the fiscal year does not coincide with the cash flow needs of most issuers. The Committee proposes three alternative methods to implement testing as of dates appropriate to the issuer. The Committee believes that any of the three methods will address the difficulties created by the proposed start of fiscal year testing date.

The Committee also recommends establishing a maturity safe harbor for extraordinary working capital, and expanding the definition of extraordinary working capital. Existing Regulations allow bonds to be issued for certain extraordinary non-capital expenditures (e.g., large tort settlements), but provide no guidance on how long such bonds may remain outstanding.

The Committee suggests a clarifying modification to the definition of available amount to exclude proceeds of any issue and provide examples to show why this is important.

The Proposed Regulations provide an appropriate framework for treatment of tax-exempt bond proceeds allocated to grants. State and local governments do make grants for a variety of purposes. States and their agencies and instrumentalities often grant money to local governments as well. Local governments often grant moneys to both for-profit and non-profit organizations to encourage certain activities. These Comments request clarification of the treatment of grants. The Committee finds the changes included in the Proposed Regulations useful, but in need of clarification.

These Comments provide detailed regulatory language (including language for examples). The Committee believes that the examples provided will explain the Regulations when finalized as applied to most transactions.

I. Ordinary Working Capital Provisions

The Existing Regulations contain a structure for state and local governments to finance certain cash flow shortfalls resulting from a variety of causes, generally tax and other revenues that are collected only a few times during the year. The Proposed Regulations are generally very helpful to issuers of tax-exempt bonds to finance these cash flow deficits. It is clear that these proposed rules act as a whole and that the different parts need each other for proper operation. For example, the elimination of a two-year temporary period for debt to be paid from a single tax collection might be very disruptive if not for the proposed provisions allowing longer term financings. Taken together, however, these two provisions should not seriously disrupt common financing techniques.

The Committee commends the Service and Treasury for the proposed simplification related to the reasonable working capital reserve. An amount of five percent (5%) of the prior fiscal year's expenditures should provide an adequate reserve. Current law restrictions on financing a reserve are difficult to administer and create perverse incentives.

The Committee is also pleased with proposed rules that create a framework for longer term working capital financing based on formal guidance.4 The Committee believes that the proposed rules are intended to capture the concept that longer term restricted working capital be allowed where an issuer takes steps to assure that the market will not be burdened any more than it would be as a result of a series of permitted one year short-term restricted working capital issues, such as annual tax and revenue anticipation notes ("TRANs"). The Committee appreciates the notion that unburdening may be achieved by the purchase of tax-exempt investments or redemption of bonds other than those financing the working capital expenditures.5 The Committee recommends that final Regulations clarify that demand deposit series state and local government series certificates of indebtedness ("Demand Deposit SLGS") be treated as non-AMT tax exempt investments for this purpose.

While these proposed rules are generally welcome, some changes and clarifications are recommended to improve their application. As described in section A below, the most important change required to the Proposed Regulations concerns testing for available amounts at the start of the fiscal year. The Committee also suggests certain changes to other regulatory provisions so that the rules work better together.

A. Longer Term Working Capital Financings

The Proposed Regulations create a structure for longer term working capital deficit financings that requires annual testings of available amounts coupled with remediation to avoid overburdening the market. Testing under the Proposed Regulations is not, however, on the appropriate date in most circumstances. Additionally, certain clarifications are needed.

1. Measurement Date Problem

When any restricted working capital bonds (including TRANs) are issued, the first testing date under both the Existing Regulations and the Proposed Regulations is as of a date that the issuer experiences or expects to experience low cash balances. The expected available amount on such date is used to size the issue. The following example may help to understand the process.

Bond issuer M is a municipality that maintains its financial records using a calendar year as a fiscal year. M provides police, fire protection, residential trash collection and snow removal services to its residents. Payrolls are paid every other Friday. M receives sales tax collections from the state on the 15th day of each month based on sales occurring during the previous month. The largest sales tax receipts are on December 15 and January 15. Because of overtime expenses, the first payroll in January is usually the largest payroll of any two week period. Real estate taxes are received semiannually on March 15 and September 15 (in roughly equal amounts). Assume M has longer term working capital bonds outstanding. For the last part of December 2018, the payroll is payable on Friday, January 4, 2019. On January 1, 2019 (the first day of the fiscal year), M has a substantial surplus, which is largely consumed by the January 4 payroll. If the balance on January 1, 2019, is used to determine whether an unburdening action is required, M may need to use a significant amount to redeem bonds or invest in non-AMT tax exempt investments. This would be true even though the issuer may also need to dip into its reasonable working capital reserves to meet payrolls in February (or in fact may be unable to meet such payrolls without further borrowings).

Fiscal years have been established in order to report financial data consistently. Fiscal years may be unrelated to timing when expenditures must be paid. Appropriately, both the current Regulations and the Proposed Regulations use a fiscal year (rather than a bond year) to compute a reasonable working capital reserve. That use of a fiscal year conveniently allows an issuer to determine a reserve based on the total amount spent over a one-year period using data commonly prepared for other purposes. Use of fiscal years for computation of the applicable reasonable working capital reserve should not imply the use of fiscal years for measuring cash flow short falls.

2. Yearly Available Amount

The Proposed Regulations use the concept of a computed "yearly available amount." As defined in Proposed Regulations section 1.148-1(c)(4)(ii)(A)(2)6 , this is the available amount on the first day of the fiscal year of the issuer. The Committee suggests that this definition be modified.

A governmental unit may experience low available balances on specific dates during each year. Often these occur on the dates of large payroll disbursements (payrolls are generally the largest routine working capital expenditures of most governmental units). "Low balance dates" may vary year to year, but are often clustered around a particular calendar date.

Certain governmental units (e.g., school districts) experience significant fluctuations in cash balances within a year. Both revenues and expenditures are often unevenly distributed throughout a year. For example, real estate tax receipts may be received once or twice a year. If, for example, one semiannual real estate tax installment is due in June, then as of July 1, the local government may have relatively full coffers at the start of its fiscal year. On the other hand, the balance on May 31 may be very low and this unit of government might want to borrow to meet an end-of-May payroll that it could not otherwise meet because it had no available funds.

3. Suggested Modification of Proposed Regulations to Accommodate More Appropriate Testing dates

Instead of computing a yearly available amount as of the start of a fiscal year, the Committee suggests that the available amount be measured as of a date that the issuer expects to need to spend bond proceeds to meet deficits. The Committee sees three possible alternative ways to achieve this goal.

First Method — Fixed Measurement Date. An issuer with a June 30 fiscal year might expect that its biggest cash flow needs would be in February of each year (as mentioned above). Under this alternative, annual periods would be used for testing, but the periods would not be tied to fiscal years. Under existing rules, the issuer can select a bond year (as defined in Regulations section 1.148-1(b)) beginning each, say, March 1. Under this first alternative approach, yearly available amount could be defined in terms of an arbitrary annual period (e.g., a bond year) rather than a "fiscal year." Beginning on the first testing year, the bond issuer would compute a "yearly available amount" applicable to each such annual period using the available amounts as of the first day of the annual period. The actions required under the Proposed Regulations section 1.1481(c)(4)(ii)(B) would then be required for that annual period. A slightly more complicated rule would create a new category of year, a "cash flow calculation year." Like a bond year, it would be up to the issuer to select the start and end date for such a year. The Committee notes that bond years are already used for such tasks as determining whether a fund is a bona fide debt service fund and, for variable rate bond issues, for computing yield periods and rebate. Since those tasks are unrelated to available amount testing, the Committee thinks it better to create a new category of issuer selected year. However, use of a "bond year" for defining yearly available amount would work fairly well. If such approach were to be used, issuers of bonds for working capital expenditures would very likely select bond years based on cash flow projections, then accept whatever effect that provides for bona fide debt service funds, rebate and variable rate yield computations. If the fixed date method is adopted, the Committee thinks that a separate category of annual period should be used rather than bond year to avoid inefficient selections of bond year for other purposes.

Because the date with the lowest available amount is very likely to be different in different years, this fixed measurement date approach is likely to result in slightly greater unburdening actions than would be required if the issuer could select its lowest balance date each year.

Second Method — Variable Measurement Date. The expected low balance date is usually not exactly the same calendar date each year. For example, payrolls may be every other Friday. An issuer might appropriately want to test on different dates each year. Our preference is that instead of using fixed one-year periods for testing and unburdening, the issuer should be permitted to declare the date when each cash flow period would end and the date the next one begin. Each cash flow calculation period would be limited to 13 months or shorter in duration. Testing periods could be shorter than one year. If an issuer decides that it would have a significant cash flow deficit five months after the start of a cash flow period, the next testing date could be set at five months later. A tax collection agent (usually a state or county) may change the date on which it turns over tax and other revenue receipts to the issuer (e.g., a municipality or school district) or the due date for taxes may be changed by law. In such a situation, a bond issuer might want to change the date on which available amounts are tested. By testing more often in one year, the issuer could return to a reasonable schedule of testing.

If this variable testing date approach is accepted, the defined term “period available amount” would replace “yearly available amount” and would apply to each “cash flow calculation period.” Otherwise, the same rules provided in Proposed Regulations section 1.148-1(c)(4)(ii)(B) would apply.7

The Committee thinks that this second method would be the optimal method. It would allow an issuer to select testing dates that most closely matches its needs. This method would also be relatively simple to administer.8 Unlike the third method described below, the test results would be verifiable based on financial records.

The Committee notes that if this variable measurement date method is adopted, an issuer would have the option of selecting a single calendar date to begin and end all testing periods. An issuer might choose to do so to simplify its procedures. Effectively, the fixed measurement date method is included as an option in the variable measurement date method.

Third Method — Projection Method. Under this method, once each year, based on either bond year or fiscal year, the issuer would project the lowest cash position date expected during the year beginning on that date. (This is similar to how an issuer would size a TRANs issue.) The yearly available amount would be the available amount expected (as of the start of the year) on the expected low balance date that year. The required unburdening action would then be taken at the start of the year (after an initial period) based on these projections. Unlike the first two methods, this method would base actions on reasonable expectations as of the start of the year. While the Committee thinks this method could work, it recognizes the imprecision inherent in a projection method as compared to a method based on actual facts. The first two methods described above are simpler to administer and simpler to enforce.

Proposed Regulations section 1.148-1(c)(4)(ii)(A)(2) should be modified to replace fiscal year references with references to bond year, cash flow year or cash flow calculation period as described above. Alternatively, the yearly available amount could reference a projected cash flow deficit date. In any event, testing should not be mandated as the first day of the fiscal year.

4. Determination of First Testing Year

As worded in Proposed Regulations section 1.148-1(c)(4)(ii)(A)(1), the issuer of bonds must determine the first year in which it expects to have available amounts for the financed working capital expenditures. What should be determined is the first start of a cash flow year or cash flow calculation period in which the issuer expects to have amounts available for expenditures of the type financed. Clearly the actual financed expenditures will be paid (or would at least be expected to be paid) during the temporary period, before any such testing is likely to occur.

Clarification is also needed about the first testing year (or period). In Proposed Regulations section 1.148-1(c)(4)(ii)(A)(1), the first testing year may not be later than five years after the issue date. This requirement is imprecise because it measures the length of time from a specific date to a period. Either the start of the first testing year (or period) (the first testing date) or the end of the first testing period must be within this five years. The Committee does not express a preference for either the start of the period or the end of the period, but the Committee recommends that the Proposed Regulations clarify which is meant. In our attached suggested language, the Committee has arbitrarily used the start of the first testing year (period). The Committee believes that issuers would generally prefer that the rule be based on the start of the period.

Note that, as a result of the five year rule, bond issues that are shorter than five years to final maturity might not require a proper showing of expectations for any post issuance tests (other than for rebate compliance). The Committee expects that many issuers will structure their bonds to avoid post issuance testing. The Committee thinks that this is appropriate for relatively short term (e.g., five year) financings.

5. Durations of Remediation

Proposed Regulations section 1.148-1(c)(4)(ii)(B) is currently drafted to state that if tax-exempt investments are used to lessen the burden on the market, such investments should be maintained "for as long as the applicable portion9 of the issue remains outstanding."

The annual testing and unburdening actions are designed to mimic a series of properly sized TRANs. Accordingly unburdening actions should only apply during the period covered by the test. On the next testing date the process should be repeated.

If expenditures exceed receipts so that available cash is reduced, the issuer should be able to liquidate and spend amounts invested in tax-exempt investments so long as available amounts are not invested in other (taxable) investments. Denial of the right to make such liquidations would only encourage more working capital borrowing. Upon the next testing date, the issuer will be required to test again. If there are no available amounts on that testing date, then for the entire subsequent cash flow year (period), the issuer should not be required to make such investment. If there are available amounts on that testing date, the amount to be invested in eligible tax-exempt investments should be re-determined as of that testing date. Finally, if the issuer chooses to redeem bonds to meet its obligation under Proposed Regulations section 1.148-1(c)(4)(ii)(B), it should be able to liquidate tax exempt investments and use the proceeds to redeem bonds.

6. Use of Conduit Issuers For Working Capital Borrowings

While most bonds financing working capital are issued directly to the public (or are privately placed directly with a bank), some units of local government issue such debt using conduit issuers, often state authorities.10 Because Proposed Regulations section 1.148-1(c)(4)(ii) requires action by the issuer, it is important to clarify that references to the issuer may be treated as references to the conduit borrower. The current definition of issuer in Regulations section 1.148-1(b) does accommodate this. It would be useful for the IRS to clarify that actions required under Proposed Regulations section 1.148-1(c)(4)(ii) can be taken by a conduit borrower. This may be done by a simple discussion of this issue in the preamble, an addition to the definition of issuer, or the inclusion of an example where the unburdening actions are taken by a conduit borrower.

II. Extraordinary Working Capital

Existing Regulations include an exception to the working capital restrictions for extraordinary working capital not customarily payable from current revenues. The Proposed Regulations provide a temporary period applicable to financings of extraordinary working capital but do not change the definition of “extraordinary items” set forth in Regulations section 1.148-6(d)(3)(ii)(B). The current definition is limited to items that are “not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage.” The Proposed Regulations also include: (i) the addition of extraordinary working capital to the list of items that may justify a bond term beyond the maturity safe harbors against the creation of replacement proceeds, and (ii) broadening the application of the 13-month temporary period exception to yield restriction for restricted working capital to include all working capital expenditures. The Proposed Regulations do not provide any safe harbor to avoid the creation of replacement proceeds, or to establish that bonds issued for extraordinary working capital purposes are not outstanding longer than necessary. Of course, an issuer could apply the rules created for restricted working capital financings to extraordinary working capital financings, but that does not seem appropriate.

Therefore, the Committee suggests providing an additional safe harbor based on weighted average maturity for longer term extraordinary working capital financings. Bonds financing extraordinary working capital expenditures generally finance casualty losses, judgments or other unexpected significant payments. Often these are a result of tragic tort liability for the governmental unit or arise from natural disaster.

By definition, extraordinary working capital expenditures are non-recurring and relatively unusual events. Because the triggering events are expected to occur infrequently, it makes sense to allow a reasonably long time to repay such borrower amounts. The Committee thinks that bonds financing such expenditures should not be considered outstanding longer than necessary if the weighted average maturity date of the bonds is not more than 15 years after the issue date. While tragedy can strike a single governmental unit multiple times, units of government experiencing such extraordinary items need to use revenues from many years to make such payments. Because such expenditures are non-recurring, financing these expenditures is most like financing capital expenditures.

If a 15-year weighted average maturity safe harbor is adopted, the rule should acknowledge that a longer period may be appropriate if the financed expenditures are so large that they exceed an amount that can reasonably be repaid in 15 years. For example, if the financed catastrophe costs exceed 75% of the total annual operating budget of the unit of government, the amount of principal to be retired each year would average more than five percent of the operating budget for an average year if the debt were repaid over only 15 years.

The Committee believes that there are circumstances where, because of their magnitude and the time it took to generate the cash flow need, payments should be classified as extraordinary non-recurring expenditures even if there is no judgment or single catastrophe event. For example amounts that a bankruptcy court orders a bankrupt unit of government to pay should be treated as extraordinary. Just as deferred maintenance can lead to required capital expenditures that could have been avoided with proper maintenance, deficits that have built up over many years should be treated as creating extraordinary non-recurring expenditures, so long as the unit of government adopts a plan to balance its future expenditures and receipts.

The Committee recommends moving the definition of extraordinary items to Regulations section 1.148-1(b) and broadening the definition of extraordinary working capital to include financing certain large accumulated deficits or amounts ordered paid by a bankruptcy court. The expenditure rules of Regulations section 1.148-6(d) should not be changed in this respect.

III. Clarify Available Amount Definition

Confusion exists if the proceeds of one issue of working capital obligations are treated as available amounts for purposes of a second issue of working capital obligations. Generally, available amounts are those available for working capital expenditures of the type financed by a bond issue. The definition in Regulations section 1.148-6(d)(3)(iii)(A) contemplates that the proceeds of any debt (including working capital obligations) are not available amounts. However, the Service has ruled that for purposes of spending the proceeds of a tax-exempt working capital issue, the proceeds of a second, taxable issue of working capital obligations are available amounts. 11 This leads to absurd results, particularly for issuers of long term working capital financings.

For example, in 2015 an issuer might issue $10 million eight-year bonds to finance working capital expenditures. The issue could be sized so that the issuer would not expect to need to take actions under Proposed Regulations section 1.1481(c)(4)(ii)(B) because it did not expect to have available amounts in each of the eight years.

However, if the issuer's fiscal situation were to deteriorate in 2021, it may need to issue an additional $2 million of bonds for restricted working capital purposes (which could be short-term or long-term bonds). Suppose that even after such borrowing, the issuer will exhaust all of its funds to pay a payroll on a given testing date after 2021. If proceeds of the 2021 bond issue are "available" when testing for the 2015 bonds, an action might be required that would not even be possible. If the $2 million of proceeds of the 2021 Bonds were considered available for purposes of testing the 2015 Bonds, Proposed Regulations section 1.148-1(c)(4)(ii)(B) might require investing that $2 million in tax-exempt investments despite being needed to pay bills. The issuer could not solve this problem by issuing taxable short-term bonds in 2021 unless it is clear that proceeds of the 2021 bonds (whether tax-exempt or taxable) are not considered available for the testing required for the 2015 bonds.

The Committee proposes that the Proposed Regulations clarify that proceeds of an issue are not treated as available amounts for purposes of applying the proceeds spent last rule (or the unburdening rule of Proposed Regulations section 1.148-1(c)(4)(ii)) to that issue, or to any other issue of obligations to be used for working capital expenditures. This could be accomplished with a simple change to Proposed Regulations section 1.1486(d)(3)(iii)(A) so that the second sentence refers to proceeds of "any" issue rather than just proceeds of "the" issue.12

IV. Look-Through Treatment of Grants

A. Tax-exempt bonds may be issued to finance grants from State and local governments either to other governmental entities or to non-profit or other entities to further governmental purposes. The arbitrage rules for grants relate to when and whether bond proceeds used for grants are expended and how any repayments of grants (e.g., because the grant was not used for the intended purpose) are characterized. Generally, the Committee agrees with the intent of the Proposed Regulations that an issuer should look through a grant to determine what was financed for certain purposes under the Code, that is, what the actual grant monies are spent on by the ultimate recipient; this so-called "look-through" approach makes particular sense with respect to private activity analysis and specifically the private business use test of section 141(b)(1).13 However, the Committee believes that a general look-through provision may be too broad, if applied to certain other Code sections, and clarification is therefore needed.

B. The Committee believes that the intent of the Proposed Regulations, like that of the current

Regulations, is that for purposes of sections 148 (including reimbursement) and 149(g), grant proceeds are spent upon the making of a grant. Thus (as clarified by Proposed Regulations section 1.150-1(f)(2) and notwithstanding the gross proceeds spent last rules), if a grantee uses grant proceeds for working capital purposes, the bond proceeds must be considered spent for arbitrage and hedge bond purposes when the grant is made. Similarly, bond proceeds should be considered spent for section 148 purposes where a grant is made to an unrelated third party to cover the cost of a project paid for by that grantee outside the allowable reimbursement window of Regulations section 1.150-2. The Committee also believes that look-through treatment is inconsistent with the definition of a refunding under Regulations section 1.150-1(d). Grant proceeds should be considered spent when the grant is made under section 149(d). Bonds used to make such grants should not be considered refunding bonds. The Committee is concerned that there are other instances where look-through treatment would not be appropriate and clarification is needed. Clarifying language either in the Preamble, the Regulations as finalized, or in an Example would be very helpful. Such clarification should demonstrate that look through treatment does not apply for purposes of reimbursement or refundings.

C. For purposes of assuring that bonds financing grants are not outstanding longer than necessary (including the limitation of section 147(b)), an issuer should be given the alternative of using the useful life of facilities to which the grantee has allocated grant proceeds, or be able (by facts and circumstances) to establish that a grant has a longer useful life than the facilities of the grantee to which the grant proceeds are allocated. For example, a grantor (e.g., a city) may make a grant to an entity (e.g., a for profit housing developer) for a new capital facility (e.g., a new apartment building). To ease the administration, and to be consistent with the nature of the reasonable expectations test of section 147(b), this issuer should be able to rely on the bona fide purpose of the grant for purposes of determining maturity limitations and overburdening regardless of the actual expenditures by the grantee. Such bona fide purpose of the grant may involve a facility paid for by the grantee earlier than would be permitted under the reimbursement rules of Regulations section 1.150-2. The Committee also notes that grants might be made where, from the issuer's perspective, the grant has a longer life than the assets to which the grantee allocates the proceeds of the grant. For example, a grant might be made by a city to a business to induce the business to locate in that city. The grant, by its terms, might require the recipient to operate a business in the jurisdiction for a designated period (e.g., ten years). In such instance, it seems reasonable that bonds financing the grant be permitted to have a weighted average maturity based on 120% of such "purpose of the grant" life (e.g., 12 years in this case) even if the grantee spends the grant proceeds for operations. It seems appropriate, for this purpose, to look at the facts and circumstances of the grant, to make this determination. Consequently, the Committee believes that the best approach to dealing with maturity limitations for grants is to add a separate provision to Regulations section 1.148-1(c)(4)(i)(B) dealing with bonds financing grants.

V. Inclusion of Regulatory Examples Beneficial

The Committee suggests that Treasury and the Service add examples to Proposed Regulations section 1.148-1 to show how the rules on longer term working capital financings would be applied. The Committee provides some examples below in these Comments.

VI. Proposed Regulatory Language

A. Changes to Proposed Regulations section 1.148-1

Below the Committee has reproduced the existing Regulations section 1.148-1 as proposed to be modified by Proposed Regulations section 1.148-1 and further modified by our suggested changes. To avoid clutter, the portions of Regulations section 1.148-1 and Proposed Regulations section

1.148-1 not relating to working capital matters have been omitted. The Committee does not distinguish between existing Regulations and proposed changes in Proposed Regulations section 1.148-1, but all language the Committee proposes to insert or replace is in bold.14

1.148-1(a) In general. The definitions in this section and the definitions under section 150 apply for purposes of section 148 and §§ 1.148-1 through 1.148-11.

(b) Certain definitions. The following definitions apply:

Available amount means available amount as defined in § 1.148-6(d)(3)(iii).

Bond year means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date.

Cash flow period means, in reference to an issue, each period of no more than 13 months, which begins on the date that the previous cash flow period ends and ends on the day selected by the issuer. The final cash flow period ends when the bonds are paid in full. If no ending date is selected by the issuer before the date that is 90 days after the start of the cash flow period, the cash flow period will end one year after it starts. The first cash flow period begins on the closing date.15

Cash flow year means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last cash flow years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, cash flow years will be the same as bond years.16

Extraordinary working capital expenditure means an expenditure for an extraordinary, non-recurring item that is not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. Payments ordered by a bankruptcy judge will generally be extraordinary working capital expenditures. Additionally, expenditures occurring during a single fiscal year are extraordinary and non-recurring if (i) in total they are no more than the amount by which annual expenses for the fiscal year exceed annual revenues for the fiscal year preceding the expenditure, (ii) there are no available amounts to pay the expenditures, (iii) the expenditures total at least seven percent (7%) of annual revenues for the fiscal year preceding the issue date, and (iv) the total amount of tax-exempt bonds outstanding that financed extraordinary non-recurring working capital is no more than 30% of the actual working capital expenditures for the fiscal year preceding the issuance of such bond issue.17

Restricted working capital expenditures means working capital expenditures that are subject to the proceeds-spent-last rule in § 1.148-6(d)(3)(i) and are ineligible for any exception to that rule.

(c) Definition of replacement proceeds.

(1) In general.

(2)

(3)

(4) Other replacement proceeds.

(i) Bonds outstanding longer than necessary.

(A) In general. Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that

(1) The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

(2) There will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148-10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

(B) Safe harbor against creation of replacement proceeds. As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section

(1) For the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than the temporary period under § 1.148-2(e)(3) for which the proceeds qualify;

(2) * * *

(3) * * *

(4) For the portion of an issue that is to be used to finance extraordinary non-recurring items as permitted under § 1.1486(d)(3)(ii)(B), if that portion has a weighted average maturity that does not exceed 15 years, or such longer period as may be appropriate under all facts and circumstances.

(5) For the portion of an issue that is to be used to finance or refinance a grant, if that portion has a weighted average maturity that does not exceed 120% of the life of the grant. For this purpose, the life of a grant is the greater of the average reasonably expected economic life of facilities to which the grant proceeds are allocated, or a longer life attributed to the grant by the grantor based upon the facts and circumstances of the grant.

(6) For an issue that is to be used to finance working capital expenditures and that is outstanding for a period longer than the temporary period under § 1.148-2(e)(3) or for an issue that is to be used to finance extraordinary working capital expenditures that is outstanding longer than permitted under § 1.148-1(c)(4),18 if that portion satisfies paragraph (c)(4)(ii) of this section.

(ii) Safe harbor for longer-term working capital financings. A portion of an issue used to finance working capital expenditures satisfies this paragraph (c)(5)(ii) if the issuer meets the requirements of paragraphs (c)(4)(ii)(A) and (c)(4)(ii)(B) of this section.

(A) Determine expected available amounts. An issuer meets the requirements of this paragraph (c)(4)(ii)(A) if —

(1) On the issue date, the issuer determines the first bond year19 (if any) following the applicable temporary period (determined under § 1.148-2(e)) at the start of which it reasonably expects to have available amounts for expenditures of the type of the financed working capital expenditures (first testing year), but in no event can the first testing year begin later than five years after the issue date; and

(2) Beginning with the first testing year and for each subsequent bond year for which the issue remains outstanding, the issuer determines its available amounts20 for expenditures of the type of the financed working capital expenditures as of the first day of the bond year (yearly available amount).

(B) Application of yearly available amount to reduce burden on tax-exempt bond market. An issuer meets the requirements of this paragraph (c)(4)(ii)(B) if, within 90 days after the start of each bond year in which it determines a yearly available amount, the issuer applies an amount equal to the yearly available amount for such year to redeem or invest in tax-exempt bonds that are excluded from investment property under § 148(b)(3) (that is, tax-exempt bonds that are not subject to the alternative minimum tax)(eligible tax-exempt bonds) For this purpose, a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series Program described in 31 CFR part 344 is an eligible tax-exempt bond. The maximum amount required to be applied in such manner shall equal the outstanding principal amount of the issue subject to the safe harbor in this paragraph (c)(4)(ii), determined as of the date of such redemption or investment. Any amounts invested in eligible tax-exempt bonds shall be invested or reinvested continuously in such tax-exempt bonds, except during a permitted reinvestment period of no more than 30 days in a bond year until allocated to an expenditure for which no other available amounts exist, or the end of the then current bond year.

C) Example 1: School district D experiences both seasonal and long term deficits and it expects to be unable to meet its operating expenses unless it borrows $10,000,000. D maintains a fiscal year beginning on July 1 and ending on June 30 of each year. Because of timing of receipts of real estate taxes and state aid, D generally expects that its balances of available funds will be lowest at the end of October or the beginning of November of each year. During the fiscal year ending June 30, 2015, D spent $40,000,000 from current revenues and, therefore, determines that during the Fiscal year ending June 30, 2016, its reasonable working capital Reserve is $2,000,000. On August 1, 2015, D determines that it does not expect to have sufficient available funds to make its payroll on Friday October 30, 2015, and projects that absent any borrowing, it would be unable to pay ordinary working capital expenditures in the amount of $8,000,000 after exhausting all available amounts and its reasonable working capital reserve. On September 15, 2015, state authority A issues $10,000,000 of bonds and lends all of the proceeds to D. D uses the proceeds of the bonds in the amount of $10,000,000 to meet its payroll and to pay other operating expenses. The bonds are issued at par and mature $2,500,000 each year beginning September 1, 2016, through September 1, 2019. D selects November 1 as the start of its bond year21 for this issue. D projects that its spending will increase from year to year so that its reasonable working capital reserve will be at least $2,000,000 in each subsequent year. Furthermore, it projects that its total cash balance as of November 122 of each year from 2015 through 2019 will be less than $2,000,000. Based on the above, D determines that its first testing year23 for this bond issue will be the bond year beginning November 1, 2019,24 by which date all of the bonds will have matured. Neither A nor D is required to test actual cashflows on any future date because no bonds will be outstanding on any future testing date. Both A and D are required, however, to determine whether the bonds meet the six month exception to rebate (because D has spent all proceeds on the bonds at times when D had no available cash). If the rebate exception is not met, D will need to compute and pay rebate at the times required under § 1.148-3 (60 days after final maturity of the bonds, which will have been outstanding for less than five years).

Example 2. The facts are the same as in example 1, except that the bonds mature $1,000,000 each year beginning December 1, 2021, through December 1, 2030. The bonds maturing on or after December 1, 2026, are callable at par (plus accrued interest) on any day on or after December 1, 2025. Based on the above, D determines that its first testing year for this bond issue will be the bond year beginning November 1, 2019. Unlike Example 1, bonds will be outstanding on this date, so testing is required.

Example 3. The facts are the same as in example 2. On December 15, 2019, D determines that on November 1, 2019, its total cash position (not including any restricted amounts) was under $2,000,000. D also determines that during the fiscal year ending June 30, 2019, it actually spent $50,000,000 from current revenues, so that its reasonable working capital reserve was at least $2,500,000 on November 1, 2019. As a result, no action will be required for the first testing year. D had no available amounts on the first day of the first testing year. The yearly available amount for the first testing year was $0.

Example 4. The facts are the same as in examples 2 and 3. On December 20, 2020, D determines that as of November 1, 2020, its unrestricted balance including its reasonable reserve was $4,000,000, but for that same date its reasonable working capital reserve was $2,000,000. No later than 90 days after November 1, 2020 (i.e., no later than January 30, 2021), it must take an appropriate action to reduce the burden on the tax-exempt market. To do so, D purchases $2,000,000 U.S. Treasury Certificates of Indebtedness of the Demand Deposit State and Local Government Series. These certificates of indebtedness are eligible tax-exempt investments. On April 30, 2021, D finds that its unrestricted cash position is reduced to $3,000,000, including its eligible tax-exempt investments and its reasonable reserve. To meet expenditures on April 30, it liquidates part of the investment in eligible tax-exempt investments, reducing its eligible tax-exempt investments to $1,000,000. This is permitted because D had no other available amounts with which to pay these expenses. On May 1, 2021, D decides to liquidate its certificates of indebtedness and purchase in their place $1,000,000 of tax-exempt governmental (non-AMT) general obligation bonds of State S. D may liquidate the certificates of indebtedness on May 1, 2021, and purchase the general obligation bonds on May 30, 2021, because up to 30 days may be used each testing year to facilitate reinvestment. For this purpose, D is treated as the bond issuer and A need take no action.

Example 5. The facts are the same as in examples 2, 3 and 4. On November 15, 2021, D determines that as of November 1, 2021, its reasonable working capital reserve was at least $3,000,000 and its unrestricted cash on hand was $2,500,000. No action is required during the testing year beginning November 1, 2021 to unburden the market. Any remaining eligible tax-exempt investments may be liquidated at the option of D. D makes similar determinations at the start of each bond year (November 1). When necessary, D purchases the appropriate amount of eligible tax-exempt investments during the first 90 days of each bond year.

Example 6. The facts are the same as in examples 2 through 5. On November 15, 2026, D determines that its unrestricted cash exceeds its reasonable working capital reserve by $2,000,000. D uses this $2,000,000 on December 1, 2026, to redeem bonds of this issue that would otherwise have matured in 2029 and 2030. After the redemption the outstanding amount of bonds is reduced to $2,000,000 ($6,000,000 matured, and $2,000,000 called early.) The redemption is a sufficient action to unburden the tax-exempt market.

Example 7. The facts are the same as in examples 2 through 6. On November 15, 2027, D determines that its available amount on November 1, 2027, was $20,000,000 (in part because real estate taxes historically collected in November were collected in October.) D only needs to take an action to unburden the market with $2,000,000 because only $2,000,000 of bonds remain outstanding on November 1, 2027. On November 15, 2027, D redeems $2,000,000 of bonds that would otherwise have matured on December 1, 2027, and December 1, 2028. After this redemption, no bonds of this issue remain outstanding, and no more testing is required.

B. Changes to Regulations section 1.148-6

The highlighted change to Regulations section 1.148-6 indicated below should be made. The bold phrase “all issues” is intended to replace the current “the issue”.

§ 1.148-6(d)(3)(iii) Definition of available amount.

(A) In general. For purposes of this paragraph (d)(3), available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of all issues [debt obligations] but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

* * * * *

QUALIFIED HEDGES

EXECUTIVE SUMMARY

The qualified hedge Regulations for tax-exempt bonds provide the rules for when and how an interest rate hedge is taken into account for purposes of computing the arbitrage yield on hedged bonds. A hedge that meets certain specific rules will be a qualified hedge. These rules relate to, among other things, the modification of risk of interest rate changes, the lack of investment element in the hedge contract, and the identification of the hedge contract on the issuer’s books and records. A hedge that meets these rules is eligible for so-called integrated hedge treatment.25 The Committee thanks the Service and Treasury for several helpful changes to the Regulations on qualified hedges. In addition, we have the following comments and recommendations.

Regarding the changes in the Proposed Regulations in connection with certain deemed terminations of qualified hedges, the Committee recommends that the hedge not be required to meet the interest rate correlation test in the 2007 Proposed Regulations26 , as defined below (in addition to the proposed new rule that the fact that the hedge is off-market is disregarded). Requiring the hedge to be modified to meet a simplified interest rate correlation test serves no purpose and substantially reduces the utility of the proposed new rules.

Regarding the changes in the Proposed Regulations to the 2007 Proposed Regulations dealing with the fair market value standard in connection with an actual termination of a qualified hedge, the Committee urges the Service and Treasury to withdraw these proposed changes, and to revert to the 2007 Proposed Regulations on this section, with certain suggested modifications. The Committee believes the proposed new rule for a specific hedge provider certificate is unwarranted. If the hedge provider certificate is retained, we have some suggested modifications.

Certain other clarifying recommendations are also made.

I. Proposed Regulations section 1.148-4(h)(3)(iv)(C)-(D) — Changes in accounting for qualified hedges in connection with deemed terminations

Proposed Regulations section 1.148-4(h)(3)(iv)(C) provides that the modification of a qualified hedge that otherwise would result in a deemed termination of the hedge (e.g., when hedged bonds are actually redeemed, or treated as reissued under Regulations section 1.1001-3) will not be treated as a termination if the modified hedge meets the requirements for a qualified hedge, determined as of the date of the modification. Proposed Regulations section 1.148-4(h)(3)(iv)(D) provides that what otherwise would be a deemed termination of a qualified hedge as a result of redemption of the hedged bonds will not be treated as a termination, and the hedge will be treated as a qualified hedge of the refunding bonds, if it meets the requirements for a qualified hedge as of the issue date of the refunding bonds. In both cases, the fact that the existing hedge is off-market as of the date of the modification or refunding, as the case may be, is disregarded. In addition, the new certification requirement is waived, and the identification requirement is measured as of the new testing date.

These proposed changes are helpful. However, when read in conjunction with other aspects of the still-pending 2007 Proposed Regulations, they are incomplete. As the Service and Treasury know, the 2007 Proposed Regulations would amend the qualified hedge rules by modifying the interest based contract rule to require, in the case of an interest rate swap based on a taxable interest rate, that the difference between the rate on the swap and the rate on the hedged bonds cannot exceed 25 basis points both at the time the issuer enters into the hedge and for a three-year period prior thereto (the "interest rate correlation test").

While not entirely clear, the Committee reads the rule in the Proposed Regulations on potential deemed terminations to require testing for compliance with the interest rate correlation test at the time of the modification or refunding to determine whether the modified or existing hedge is a qualified hedge.27 That will greatly limit the utility of the new rules.

The Committee believes that the interest rate correlation test for qualified hedges generally is unnecessary in light of other rules. But the Committee also suggests that, if some form of interest rate correlation will be required, that correlation be limited to a three-year historical correlation. Assuming the interest rate correlation test (with a three-year historical correlation) is the rule finally adopted, the Committee urges the Service and Treasury not to require its application in connection with potential deemed terminations as a result of a modification or refunding. One of the great benefits of the Proposed Regulations is that an issuer will not need to negotiate with an existing hedge provider to maintain the qualified status of its hedge when the potential deemed termination occurs. This is most commonly the case in connection with refundings of hedged bonds (including deemed reissuances), but it can also occur in connection with deemed modifications as a result of new interest rate positions entered into with a counterparty different from the original hedge provider. If the interest rate correlation test must be satisfied as of the date of modification or refunding, the issuer will almost certainly have to deal with the original hedge provider to ensure compliance.

The Committee submits that interest rate correlation in these circumstances is unnecessary, because a single rate correlation test can always be satisfied with a meaningless adjustment to the rate formula. For example, assume an issuer's three-year historical interest rate for a particular rate period has averaged two percent, and it has an existing interest rate swap where the issuer pays four percent fixed and receives 67% of LIBOR (which satisfied the interest rate correlation test at the time it was entered into). If LIBOR for the three-year test period prior to a refunding has averaged 2.46%, then 67% of LIBOR for that period would have averaged 1.60% — more than 25 basis points different from two percent. That difference can be eliminated by changing the interest rate formula on the swap by adding 40 basis points to each side of the equation, to make the fixed rate 4.40% and the variable rate 67% of LIBOR plus 40 basis points. Simple algebra will prove that those two rate formulas will always produce the same net number, and the same will be true for virtually any other set of rate formulas. That is easy enough to do when the swap is being entered into, when both parties to the contract are at the table. But it is needless expense in time and money to force the issuer to do that when the contract is not otherwise being touched.

As an alternative to abandoning the interest rate correlation test altogether, the Committee suggests that the issuer be permitted to satisfy that test by maintaining documentary evidence that the test could have been satisfied with an adjustment to the interest rate provisions in the swap that would have produced no net change in payments under any set of interest rate assumptions.

The Committee suggests that the Service clarify that these rules, if and when finally adopted, will supersede section 5.1 of Notice 2008-41, dealing with modifications of qualified hedges.

II. Proposed Regulations sections 1.148-4(h)(3)(iv)(A)-(B) — Definitions of modification and termination for qualified hedges

While the Committee has no specific comments to these provisions, it does have the following observations.

The removal of the phrase “acquisition by the issuer of an offsetting hedge” from the definition of a termination is an improvement to the rules.

The assignment of a hedge provider’s remaining rights and obligations under the hedge to a third party is treated as a modification under Proposed Regulations section 1.148-4(h)(3)(iv)(A), but it is also treated as a termination under Proposed Regulations section 1.148-4(h)(3)(iv)(B) only if that causes a realization event to the issuer under section 1001. Presumably that covers an assignment that is not treated as an exchange under Regulations section 1.1001-4, as recently modified. If the assignment rule is intended to have some other application, please clarify.

The Committee understands that under the Proposed Regulations a partial redemption of hedged bonds results in a partial deemed termination of a qualified hedge.

The Committee also understands that the Proposed Regulations allow an issuer to modify a qualified hedge by executing a second hedge and integrating the two hedges with the bonds without the need for a hedge provider’s certificate (assuming the other integration requirements are met).

III. Proposed Regulations section 1.148-4(h)(3)(iv)(E) — Fair market value standard for termination of qualified hedge

The 2007 Proposed Regulations would modify the Existing Regulations (which provide a safe harbor for allocating certain hedge termination payments), to provide that the amount of any termination payment or deemed termination payment taken into account for arbitrage yield calculations equals the fair market value of the hedge on the termination date. The current Proposed Regulations leave the fair market value standard for deemed terminations unchanged from the 2007 Proposed Regulations and add the rule that, in the case of an actual termination, the amount taken into account cannot be more than fair market value if the termination payment is paid by the issuer and cannot be less than fair market value if the termination payment is paid by the hedge provider. Although the Preamble to the Proposed Regulations states that these changes were made in response to comments, there is no further explanation on what issues the Proposed Regulations are intended to address. The Committee is unsure of the object of this proposal.

In most cases hedge termination payments are determined initially by the provider based on its pricing models and typically reflect the “bid side” of the hedge provider’s quotation system. Standard swap documentation usually provides for a market quotation procedure if the issuer disagrees with the provider’s termination amount, which will again be based on the “bid side.” This is the same system used for interest rate swaps for non municipal counterparties, and the Committee is unaware of any suggestion that the system produces off-market results. Especially in the case of an actual termination payment, the termination amount is a real number to the issuer, either a real cost or a real revenue; a bond yield adjustment will at best only partially compensate an issuer for an off-market termination amount.

In view of standard practice throughout the hedge market and the administrative development of this new proposed rule, the Service and Treasury should make clear the implication of the Proposed Regulations' treatment of termination amount values. Fair questions include whether Treasury and the Service think every termination value determination is suspect; whether Treasury and the Service think hedge parties are burying other costs into swap termination values. In the latter case, the questions would be a proper subject of an audit challenge under the current rules.

Moreover, the landscape for derivatives has changed tremendously since 2007, most notably by enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203) ("Dodd-Frank"). Under the price transparency rules for interest rate swaps under Dodd-Frank, municipal issuers and their advisors (and all municipal issuers are required under Dodd-Frank to have swap advisors) have real time pricing information to help them determine the true value of their swaps.

The Committee urges Treasury and the Service to revert to the 2007 Proposed Regulations statement of the fair market value rule, with the following changes:

(i) in the case of an actual termination of a qualified hedge, the termination amount is the amount paid by or to the issuer in respect of such termination, and

(ii) in the case of a deemed termination of a qualified hedge, the termination amount is the fair market value determined by the issuer (taking into account any quotation of such value obtained from the hedge provider and any quotation obtained from a reasonably comparable provider).

`In either case, Treasury and the Service should recognize that real world termination values reflect the "bid side" of the market.

Finally, it is unlikely that there will be a single universally agreed-upon fair market value for a hedge, because different buyers will be willing to pay different prices for the same product. In other contexts (e.g., fair market value for issue price), industry practice has developed to permit parties to certify that a price represents "a fair market value." The Proposed Regulations should be modified to use the words "a fair market value" or simply "fair market value" in place of "the fair market value."

IV. Proposed Regulations section 1.148-4(h)(2)(viii)(A) and (B) — Requires specific hedge provider certifications for qualified hedge treatment

The Proposed Regulations would impose a hedge provider's certification requirement for qualified hedges. This requirement seems unnecessary for several reasons. First, it would impose a requirement on qualified hedges that is not present for other financial contracts that are includable in yield. For example, there is no similar requirement for bond insurance or letters of credit, although we acknowledge similar provisions relating to investment of bond proceeds in guaranteed investment contracts. Issuers have strong legal, market and economic incentives to seek the most qualified swap counterparties.

Second, interest rate swaps and other hedges function as a form of interest rate protection, similar to the credit risk protection provided by a guarantee. Under the Regulations, if an issuer acquires a qualified guarantee, the fees includable in bond yield cannot exceed a reasonable arm's-length charge for the transfer of credit risk.28 Importantly, in complying with this requirement, the issuer may not rely on representations of the guarantor. It would be inconsistent for the qualified hedge regulations to have disparate treatment between qualified hedges and qualified guarantees.

Third, hedge integration is not unique to the tax-exempt bond area, and the requirement in the

Proposed Regulations for a hedge provider's certificate is unprecedented. More specifically, none of the hedge integration regulations set forth under sections 446, 988, 1221 and 1275 contain a requirement for a hedge provider's certificate. In addition, issuers have been integrating hedges with tax-exempt bonds for more than 20 years without this requirement. There should be compelling reasons for imposing a different requirement in the tax-exempt bond area than in under general tax law.

If the Service and Treasury seek to set forth an explicit "fair market price" concept to qualified hedges, the Proposed Regulations should be modified to provide for alternative methods of establishing fair pricing, which could include a hedge provider's certificate, internal analysis, or a report of a qualified independent representative meeting the standards of the Commodity Futures Trading Commission. Moreover, where interest rate swaps are bid, with the issuer specifying the variable rate leg and the swap being awarded to the lowest fixed rate bidder, the awarded price should conclusively establish fair market price.

The Committee recognizes, of course, that most issuers (at the instigation of bond counsel) already require hedge provider certifications. It is unlikely to be coincidence that the content of the provider's certificate in the Proposed Regulations reflects to some degree a standard form of such certification. Nonetheless, we believe the Proposed Regulations should set forth only the substantive requirements for qualified hedge treatment and should allow the market to develop appropriate standards for implementing those requirements.

If the Service and Treasury decide to retain the certification requirement, the four representations currently in Regulations section 1.148-4(h)(2)(viii)(B) should be clarified. As a general matter, the Committee believes that the form of the certificate and the precise phraseology should not dictate the tax result. The issuer should be required to demonstrate that it used its best efforts to establish that (1) the rate payable by the issuer does not include compensation for underwriting services, and (2) the rate was comparable to the rate that the hedge provider would charge for a similar hedge with a counterparty similar to the issuer (if one exists). The lack of a comparable hedge or comparable hedge counterparty should not preclude hedge integration.

Specifically, the Committee sees little value in a representation that the terms of the hedge were agreed to between a willing buyer and willing seller in a bona fide, arm's length transaction. Hedges are typically (although not always) negotiated transactions, and issuers frequently use swap advisors (or internal expertise) to evaluate transactions. As drafted, the representation is a legal conclusion that appears to create a "foot fault" to deny integration (or create potential liability for the hedge provider) if the Service disapproves of the integrated hedge transaction.

The rate comparability representation in Proposed Regulations section 1.148-4(h)(2)(viii)(B)(2) is generally fine, but the reference to "debt obligations other than tax exempt bonds" should be deleted. Many tax exempt bond issuers do not issue taxable debt obligations. Moreover, the legal, credit and other market factors present in hedges with tax exempt issuers are materially different from the same factors when a taxable entity is a counterparty.

The Committee has a minor comment to the disclosure of third party fees as required by Proposed Regulations section 1.148-4(h)(2)(viii)(B)(3). This section should clarify that it only requires third party fees paid at the request (or for the benefit) of the issuer to be disclosed in the certificate. Third party fees, such as legal and accounting fees, paid by the hedge provider for the benefit of the hedge provider should be not be required to be disclosed. This clarification would be consistent with current market practice.

Proposed Regulations section 1.148-4(h)(2)(viii)(B)(4) is unclear. From its perspective, the hedge provider is offering to enter into a bilateral contract with the issuer. It is inappropriate for the hedge provider to address whether the hedge modifies the issuer's risk of interest rate changes. Similarly, it is inappropriate for the hedge provider to represent that the payments are reasonably allocated to the hedge provider's overhead. The Committee assumes that the Service and Treasury are concerned about hedge providers embedding fees for other services within a hedge. Market practice has addressed this issue effectively. In general, bond counsel have asked hedge providers whether amounts payable by the issuer pursuant to a qualified hedge include payment for underwriting or other services provided by the hedge provider. If the swap contains a significant investment element or the hedge provider makes payments on behalf of the issuer (e.g., a financial advisor or swap advisor to the issuer), those "services" are typically disclosed. As drafted the Proposed Regulations would not allow an issuer to integrate a hedge with a separately stated investment element or fee. If the Service and Treasury retain the hedge provider's certificate requirement, we recommend that Proposed Regulations section 1.148-4(h)(2)(viii)(B)(4) be replaced with a requirement that the hedge provider represent either (1) that there are no underwriting or other services unrelated to the hedge provider's obligations under the hedge, or (2) state the nature of the services and the rate that the hedge provider would have quoted to the issuer to enter into the hedge absent such services.

V. Proposed Regulations section 1.148-4(h)(2)(viii) — Identification

Most of the requirements for qualified hedge treatment apply to the "issuer," which in the case of a conduit financing means either the actual issuer or the conduit borrower, depending on the context.29 In Regulations section 1.148-4(h)(2)(viii), however, the identification of a hedge must be made by the actual issuer. That is, the actual issuer must identify the specific hedging transaction within a short time-period after the transaction is executed. Especially in the case of anticipatory hedges, however, a conduit borrower may not even know for sure what entity will be the actual issuer of the bonds. In conduit financings, the Regulations should permit the identification to be made on the books and records of the conduit borrower. The actual issuer would still be required to identify the existence of the hedge on the information return filed with respect to the issue. Listing the hedge on the information return should be treated as inclusion in the issuer's books and records and address any concerns that the Service may have regarding the issuer being familiar with the hedge.

VI. Proposed Regulations section 1.148-4(h)(4)(iv) — Applies section 1.148-4(h)(4)(iii) to section 1.148-4(h)(3)(iv)(C)

The Proposed Regulations would add a new section 1.148-4(h)(4)(iv) to read as follows —

Consequences of certain modifications. The special rules under paragraph (h)(4)(iii) of this section regarding the effects of terminations of qualified hedges of fixed yield hedged bonds also applies in the same manner to modifications of a qualified hedge under paragraph (h)(3)(iv)(C) of this section. Thus, for example, a modification may result in a prospective change in the yield on the hedged bonds for arbitrage rebate purposes under § 1.148-3.

This section is proposed to be added to the so-called super integration rules, which provide that certain hedged variable yield bonds will be treated as fixed yield bonds. In general, the rules under Regulations section 1.148-4(h)(4)(iii) provide in connection with termination of a super integrated hedge that (A) the hedged bonds are treated as reissued on the termination date in determining yield for purposes of Regulations section 1.148-3 (dealing with rebate), (B) if the termination occurs within five years of the issue date of the hedged bonds, the bonds are treated as variable yield bonds from their issue date, and (C) the termination rule does not apply to a termination if, based on the facts and circumstances (e.g., taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in yield.

The Committee understands that the purpose of this proposed rule is to ensure that a qualified hedge super integrated under existing Regulations section 1.148-4(h)(4)(i) is retested for super integration after a modification that would not be treated as a termination under Proposed Regulations section 1.148-4(h)(3)(iv)(C) (modification does not result in a deemed termination if the fact of its being off-market is disregarded). If that understanding is correct, we suggest the rule could be clarified if the first sentence were rewritten as follows —

Notwithstanding the rule on modification of a qualified hedge under paragraph (h)(3)(iv)(C) of this section, modification of a qualified hedge that would result in a termination in the absence of the rule in paragraph (h)(3)(iv)(C) will be treated as a termination for purposes of this paragraph (h)(4)(iii) unless the rule in subparagraph (h)(4)(iii)(C) applies.

FOOTNOTES

1 References to the Existing Regulations are to those Regulations currently effective under I.R.C. § 148.

2 References to the Proposed Regulations are to those Regulations published in 78 Fed. Reg. 56,842 REG-148659-07 (Sept. 16, 2013), unless otherwise stated.

3 For purposes of these Comments, “available amounts” has the meaning set forth in Reg. § 1.148-6(d)(3). Available amounts must generally be spent before bond proceeds are spent on “restricted working capital” items. Restricted working capital expenditures are non-capital expenditures for which no exception to the bond-proceeds-spent-last rule applies.

4 The only guidance for this topic has been in private letter rulings.

5 We observe that the flexibility of allowing an issuer to invest in tax-exempt obligations to address, in whole or in part, overburdening concerns could be made to apply to any tax-exempt financing.

6 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

7 Under Prop. Reg. § 1.148-1(c)(4)(ii)(B) an issuer is given 90 days after the start of the testing period to take certain actions. It might be appropriate to measure this “grace period” as a percentage of the testing period if periods significantly shorter than one year are allowed -for example, 25% of the testing period.

8 The Committee acknowledges that any annual testing requirement may require outside consultants to assist certain issuers.

9 The Committee notes that the “portion of” language is used in multiple places in the current and proposed versions of Reg. § 1.148-1(c). The Committee believes that the wording could be simplified because of the treatment of the multi-purpose Reg. § 1.148-9(h)-(i).

10 Some of these are stand alone financings and some are bond bank or pooled financings.

11 See PLR 200446006 (Nov. 11, 2004).

12 See section IV: Proposed Regulatory Changes

13 We assume, however, that there is no intent to change the historical interpretation of the private security or payment test of I.R.C. § 141(b)(2) such that if proceeds are granted to an unrelated third

party and neither the issuer (nor a related party) receives any payments, directly or indirectly with respect to the applicable financed project, that the private activity bond test is not satisfied. For example, a grant of proceeds to a multifamily, for-profit developer, by a city, for a housing project, would not satisfy the private activity bond test of I.R.C. § 141 merely if the developer receives rent from the housing project, provided that neither the city (nor a related party) receives such rent.

14 Certain numbering and headings are also in bold because that is how they appear in the regulations. We do not expect that this will cause any confusion.

15 Cash flow period only needs to be defined if the variable date method is used.

16 Cash flow year only needs to be defined if the fixed date method is used, and the IRS does not want to use "bond year" for this purpose.

17 We recognize that this comment letter does not explain the rationale for these numerical constraints.

18 We believe that these testing and unburdening provisions can and perhaps should logically be applicable to any tax-exempt financing, including capital project financings. Of course, those bond issues subject to § 147 of the Code would also need to comply with that provision.

19 Bond year may be replaced with "cash flow year" or "cash flow period" throughout this paragraph. Definitions of "cash flow year" or "cash flow period" would then be required and would be limited to no more than 13 months.

20 For the projection method, this definition would read: "the Issuer determines its reasonably expected available amount as of a date of its choosing occurring during such bond year (yearly available amount)." Under this method, the term fiscal year could be used instead of bond year throughout.

21 If a variable date method is adopted, this might be re-worded as "the first Friday of November as the start of each cash flow period beginning with the second cash flow period." If a fixed measurement date method based on cash flow years is used, substitute cash flow year for bond year throughout the examples.

22 If the final regulations use the term "cash flow year" or "cash flow period," then this should be modified accordingly.

23 Period if a variable method is used.

24 Earlier bond years or cash flow years begin less five years after the bonds are issued. The expectations of the issuer at closing are that there would not be any available amounts on any of these testing dates because the reserve was increasing and balances were staying the same. If a variable testing date method is used, substitute "the cash flow period beginning Friday, November, 2019."

25 That is, payments and receipts under the hedge are integrated as part of the bond yield.

26 72 Fed. Reg. 54,606 REG-106143-07 (Sept. 26, 2007) (the "2007 Proposed Regulations").

27 Disregarding any off-market aspect of the modified or existing hedge might be interpreted to include any noncompliance with the interest rate correlation test, but that seems an unlikely intent.

28 See Reg. § 1.148-4(f)(4)(i).

29 Regs. § 1.148-1(b)