COMMENTS ON REGULATIONS UNDER SECTION 148 
OF THE INTERNAL REVENUE CODE OF 1986 
AS THEY RELATE TO ESTABLISHING THE 
FAIR MARKET VALUE OF CERTAIN INVESTMENTS 
AND ESTABLISHING A SAFE HARBOR FOR 
BROKERS’ COMMISSIONS AND SIMILAR FEES 

The following comments and recommendations express the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments and recommendations were prepared by members of the Committee on Tax-Exempt Financing. Primary responsibility was taken by David A. Caprera. Members of the Committee who submitted comments were William H. Conner, William M. Loafman and Arthur M. Miller. These comments were reviewed by Frederic L. Ballard, Jr. for the Section’s Committee on Government Submissions and by Steven D. Conlon, the Council Director for the Committee on Tax-Exempt Financing.

Although members of the Section of Taxation who participated in preparing these comments and recommendations may have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments (except that one partner in the law firm in which Mr. Conlon is a partner, who did not participate in the drafting of these comments, was engaged by a client to make a governmental submission with respect to the subject matter of these comments).

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INTRODUCTION

These comments address two sets of regulations. The first set of regulations are final regulations relating to establishing the fair market value of certain investments and whether the fee paid to a bidding agent with respect to an investment in a yield restricted defeasance escrow is a qualified administrative cost. Treas. Reg. Sections 1.148-5(d)(6)(iii) and 1.148-5(e)(2)(iv). The second set of regulations are proposed regulations, which were issued in August, 1999, that provide a safe harbor in determining whether brokers’ commissions and similar fees incurred in connection with the acquisition of a guaranteed investment contract or an investment purchased for a yield restricted defeasance escrow are qualified administrative costs. Prop. Treas. Reg. Section 1.148-5(e)(2)(iii).

FINAL REGULATIONS

In late 1998, the Department of Treasury finalized regulations with respect to establishing (i) a safe harbor for determining the fair market value for guaranteed investment contracts (“GICs”) and investments for a yield restricted defeasance escrow and (ii) whether the fee paid to a broker of an investment for a yield restricted defeasance escrow is reasonable. Treas. Reg. Section 1.148-5(d)(6)(iii) and Treas. Reg. Section 1.148-5(e)(2)(iv). The final regulations are a significant improvement over the June 1996 prior proposed regulations and represent the product of an open dialogue between the Department of Treasury and practitioners. Specifically, there are three significant improvements in the final regulations over the proposed regulations.

First, the final regulations provide a safe harbor for determining the fair market value of an investment in a yield restricted defeasance escrow, rather than the rebuttable presumption
contained in the prior proposed regulations. Second, the final regulations apply to all investments in a yield restricted defeasance escrow, not just to U.S. Treasury obligations, as provided by the prior proposed regulations. Third, the final regulations delete the comparability requirement in the prior proposed regulations relating to the price of reasonably comparable U.S. Treasury obligations offered to other persons for purchase on terms comparable to those offered to the issuer from a source of funds other than tax-exempt bonds or the use of a forward pricing formula if such comparables were not available. Nonetheless, we believe that there are certain aspects of the final regulations that need to be clarified and refined.

The first comments below with respect to the final regulations are the most significant aspects of those regulations that need to be addressed. The remaining comments with respect to the final regulations are not set forth in order of importance, but instead are discussed as they appear in the text of the final regulations or the preamble thereto.

**PROPOSED REGULATIONS**

In August, 1999, the Department of Treasury issued proposed regulations that provide a safe harbor for determining whether brokers’ commissions and similar fees incurred in connection with the acquisition of a GIC or an investment purchased for a yield restricted defeasance escrow constitute qualified administrative costs. Specifically, the proposed regulations would delete Treas. Reg. Section 1.148-5(e)(2)(iv), which presently relates only to fees for an investment in a yield restricted defeasance escrow, and revise Treas. Reg. Section 1.148-5(e)(2)(iii), which presently relates only to fees for a GIC, to provide a safe harbor applicable to the purchase of both a GIC and an investment in a yield restricted defeasance escrow.
We endorse the Treasury’s efforts in providing a safe harbor for GIC brokerage fees. Issuers of tax-exempt obligations, legal counsel, investment bankers and investors in such obligations all benefit from the assurance that such a safe harbor provides.

**EXECUTIVE SUMMARY—FINAL REGULATIONS**

1. **Scope of Final Regulations; Definition of GIC.** An investment package consisting of a combination of U.S. Treasury obligations (or similar investments) and another financial tool, such as an escrow float contract, should be expressly included in the safe harbor in the final regulations because such an investment package is properly treated as “an investment” purchased for a yield restricted defeasance escrow within the meaning of the final regulations. Treasury representatives have indicated their view that the package cannot qualify as either a GIC or a defeasance investment, on the apparent ground that the safe harbor can only apply to an investment that is purely one or the other. We believe that this type of package investment is motivated by the goal of financial efficiency rather than arbitrage and is sufficiently common and advantageous that the safe harbors should be available for it notwithstanding its hybrid nature. We believe that instead of leaving hybrid contracts out of the safe harbors altogether, the regulations should clarify as between the GIC rules and the defeasance rules which applies to various forms of hybrid contracts.

Some commenting members believe that an investment in a yield restricted defeasance escrow that consists entirely of a GIC (as determined under the definition in Treas. Reg. Section 1.148-1(b)) should be treated as what it is—i.e., a GIC. Other members believe that some arrangements falling within the GIC definition should be treated as non-GIC defeasance investments that are subject to the SLGs comparability requirement. All members believe the area merits clarification.
2. **Effective Date.** In general, the final regulations should be made elective for all investments made after March 1, 1999, with respect to previously issued bonds.

3. **Reasonably Competitive Provider Safe Harbor.** The final regulations should provide an objective safe harbor as to who is a reasonably competitive provider of an investment—e.g., a provider that has delivered $20,000,000 in face amount of the type of investment being provided over the prior two years.

4. **Clarification of Material Financial Interest and Definition of a Lead Underwriter.** The final regulations should specifically (i) define who is a lead underwriter and (ii) state that any member of an underwriting syndicate that is not the lead underwriter does not have a material financial interest in the issue.

5. **SLGS Comparability Standard.** If the SLGS comparability test requires SLGS to be purchased but it is then too late to subscribe for SLGS, similar to Rev. Proc. 95-47, 1995-2 C.B. 417, a special yield reduction payment should be permitted to be made once the arbitrage on the combined portfolio of non-SLGS investments initially purchased and the SLGS ultimately purchased can be determined.

6. **Payments to Brokers.** The final regulations should be revised to permit a state or local government to recover a reasonable fee actually paid to a broker in the situation in which the brokered investment is not purchased because the SLGS comparability test is not satisfied.

7. **Reasonableness of Fees.** The final regulations should be amended to provide that a broker’s fee is reasonable “to the extent that” it does not exceed the amount specified in the final regulations.
8. **Principal Amount Versus Purchase Price.** The reference in Treas. Reg. Section 1.148-5(e)(2)(iv)(B) to “initial principal amount” should be changed to “initial purchase price.”

**EXECUTIVE SUMMARY—PROPOSED REGULATIONS**

1. **Fees In Excess of Safe Harbor.** The proposed regulations, when finalized, should specifically state that a fee in excess of the safe harbor will not be presumed to be unreasonable, but instead will be subject to the general rules relating to reasonableness.

2. **A Single Safe Harbor Is Too Inflexible.** A single safe harbor does not provide for adequate compensation for a transaction that is relatively small. There is a certain amount of work associated with any transaction, and although the amount of work does not increase proportionately as the size of a transaction increases, a $150,000,000 transaction does involve more work than a $15,000,000 transaction. A single safe harbor does not reflect this reality. Also, it may be appropriate to treat a single, long term contract as multiple shorter term contracts to reflect the complexity involved in structuring a long term contract.

3. **$75,000 Aggregate Limit Should Be Replaced With An Antiabuse Rule Or Increased.** The $75,000 aggregate limit on brokers’ commissions and similar fees has the realistic potential to alter investment decisions of state or local governments and should be replaced with a less intrusive antiabuse rule that aggregates multiple investments in certain situations.

4. **GICs Versus Other Investments.** The definition of “computational base” in Prop. Treas. Reg. Section 1.148-5(e)(2)(iii)(B)(2) is different for GICs and “investments (other than guaranteed investment contracts) to be deposited in a yield restricted defeasance escrow.” The
definition of computational base should be conformed to whatever decision is made in the final regulations as to whether a GIC in a yield restricted defeasance escrow is treated as a GIC or as an “investment” to be deposited in a yield restricted defeasance escrow.

5. **Computational Base for GICs.** The phrase “as of the issue date” should be deleted from the definition of the computational base for GICs.

6. **Effective Date.** When finalized, the proposed regulations should be electively applicable to investments made after a specified date for previously issued bonds.

**COMMENTS—FINAL REGULATIONS**

1. **Scope of Final Regulations; Definition of GIC.** The final regulations relate to two types of investments: a GIC and “an investment” purchased for a yield restricted defeasance escrow. Treas. Reg. Section 1.148-5(d)(6)(iii) (first sentence) and Treas. Reg. Section 1.148-5(d)(6)(iii)(C)(1) and (2).

In structuring a yield restricted defeasance escrow, state and local governments consider a number of investment options. These options include a portfolio consisting solely of U.S. Treasury obligations or similar investments, a mixed portfolio of U.S. Treasury obligations and State and Local Government Series securities (“SLGS”), and U.S. Treasury obligations combined with another financial tool, such as an escrow float contract or similar arrangement. In each case, the state or local government views the portfolio as a single investment.

Prior to the meeting of the American Bar Association, Committee on Tax-Exempt Financing, held in January, 1999, many practitioners believed that the safe harbor in the final regulations applied to a bid for a combination of U.S. Treasury obligations (or similar
investments) and another financial tool, such as an escrow float contract, because such an investment package constituted “an investment” in a yield restricted defeasance escrow subject to, among other things, the SLGS comparability standard in Treas. Reg. Section 1.148-5(d)(6)(iii)(C)(2)(ii). In other words, because such an investment package did not consist entirely of just a GIC, it necessarily constituted “an investment” other than a GIC. In addition, the rules for broker’s fees in Treas. Reg. Section 1.148-5(e)(2)(iv)(B) deal specifically with combined packages, recognizing that they would be sought by state and local governments. At the January, 1999, American Bar Association Tax Section meeting (and at subsequent meetings of the American Bar Association and other organizations), Treasury personnel have informally indicated that this type of combined bid was not intended to be covered by the final regulations.

As a matter of practice, many practitioners are applying the final regulations to this type of combined bid, as well as similar investment combinations. This practice reflects either a belief that the final regulations by their terms apply to such bids or, if the final regulations do not literally apply, applying the principles set forth in the final regulations will nonetheless establish the bona fides of the bidding processing.

Not to provide the safe harbor contained in the final regulations to a common practice by state and local governments lessens the efficacy of the final regulations, absent compelling policy reasons to the contrary. The practice in question is, we believe, motivated by financial efficiency rather than arbitrage. The final regulations should be revised to specifically indicate that they apply to such combined bids. This can be done by example or by adding the following parenthetical text in Treas. Reg. Section 1.148-5(d)(6)(iii)(C)(2) after the first clause thereof:
“(e.g., an investment comprised of both U.S. Treasury obligations and another financial tool such as an escrow float contract).”

Section D. of the “Explanation of Provisions” in the preamble to the final regulations states that “[t]he term guaranteed investment contract generally does not include investments purchased for a yield restricted defeasance escrow.” This conclusion means that a contract for a purchase of defeasance investments is subject to the SLGs comparability requirement, which applies to defeasance investments that are not a GIC, and it also means that the arrangement does not qualify for the broker’s fee rules applicable to a GIC that under the regulations are differently structured from those applicable to a defeasance escrow. We agree with that result, but would suggest that the matter should be dealt with in the regulations rather than merely the preamble.

The preamble continues by stating that a GIC does include “escrow float contracts and similar agreements purchased for a yield restricted defeasance escrow.” We agree with this statement, but would suggest that escrow float contracts may not be the only escrow-related arrangements that are properly classified as GICS. For example, consider a contract under which a counterparty agrees to provide cash in the amounts and on the dates necessary to satisfy the defeasance requirements on all or a portion of a prior issue, which is collateralized by U.S. Treasury obligations (and as a result, the U.S. Treasury obligations continue to be owned by the counterparty). The members commenting are in agreement that this arrangement falls within the definition of a GIC. A majority of the members commenting believe that this treatment is appropriate and that the SLGs comparability requirement ought not to apply to this type of contract. A minority of the members commenting believe that this type of contract ought not to be excluded from the SLGs comparability requirement. These members would suggest that the
regulations should include a rule to the effect that a GIC that provides defeasance payments should be subject to SLGs comparability requirement, and that this result could be achieved either by revising the definition of a GIC or revising the provisions of the safe harbor.

Treas. Reg. Section 1.148-1(b) defines the term “guaranteed investment contract” to include any nonpurpose investment that has specially negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also to include any agreement to supply investments on two or more future dates (e.g., a forward supply contract). This definition predates the safe harbor regulations and therefore does not include guidance as to whether any contracts covered by it should be treated differently from other GICs for purposes of the safe harbor regulations. Some members commenting believe that no distinction of this type should be made, on the ground that the market for GICs related to defeasance escrows is essentially the same as the market for GICs generally. Other members believe that GICs that provide a defeasance escrow are a unique market that should be recognized as special by the tax laws, in particular by subjecting these GICs to the SLGs comparability requirement.

In reaching a conclusion on this question, it may be helpful to draw a line between those investment decisions that are made in connection with the creation of a yield restricted defeasance escrow and those that are made after the date a yield restricted defeasance escrow is created. As stated above, when a GIC is used in combination with other investments at the time that a yield restricted defeasance escrow is created, it may be appropriate to treat such a hybrid investment package as an “an investment” other than a GIC. However, if after the initial creation of a yield restricted defeasance escrow, a GIC is used by itself to restructure a yield restricted defeasance escrow, some members believe there is no sound policy reason to treat it as anything other than what it is – i.e., a GIC. Other members believe that the policy behind
subjecting defeasance escrows to the SLGs comparability requirement should apply in this case as well.

This confusion is raised primarily by the preamble to the final regulations. This confusion can be eliminated by adding a discussion in the preamble to the notice providing clarification and corrections to the final regulations to the effect that an investment that is a GIC (as defined in Treas. Reg. Section 1.148-1(b)) will be treated as a GIC for purposes of these rules even though it is deposited in a yield restricted defeasance escrow if that is the policy conclusion that is reached. Also, in the first sentence of Treas. Reg. Section 1.148-5(d)(6)(iii), the phrase “the purchase price of an investment purchased for a yield restricted defeasance escrow” could be changed to “the purchase price of any other investment purchased for a yield restricted defeasance escrow.”

2. **Effective Date.** The regulations are applicable to bonds sold on or after March 1, 1999, subject to a limited transition rule. For bonds issued prior to March 1, 1999, an issuer should be given the opportunity to elect to have the safe harbor provisions apply. However, there should be no negative implication that failure of an issuer to elect to have the regulations apply suggests that the investments were acquired for other than fair market value.

3. **Reasonably Competitive Provider Safe Harbor.** A reasonably competitive provider is currently defined in Treas. Reg. Section 1.148-5(d)(6)(iii)(A)(7) as “a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.” This definition is subject to a great deal of latitude in its interpretation. To provide an objective standard in construing this definition, the following safe harbor should be added to
Treas. Reg. Section 1.148-5(d)(6)(iii)(A)(7): “A provider of an investment will be treated as a reasonably competitive provider of the investment being provided if, over the two-year period immediately preceding the provider’s bid to provide an investment, the provider has delivered $20,000,000 in face amount of the type of investment being provided.”

4. **Clarification of Material Financial Interest and Definition of a Lead Underwriter.** Treas. Reg. Section 1.148-5(d)(6)(iii)(B)(1) indicates that “[a] lead underwriter in a negotiated underwriting transaction is deemed to have a material financial interest in the issue until 15 days after the issue date of the issue.” The negative implication of this statement is that any member of an underwriting syndicate that is not the lead underwriter does not have a material financial interest in an issue. It would be useful to state this explicitly in the final regulations.

The meaning of the phrase “lead underwriter” should be clarified. The preamble refers to “the lead underwriter” suggesting there is only one; the text of the final regulations is written in terms of “a lead underwriter” which implies multiple parties. If two underwriters have been designated as co-lead underwriters, although only one is the “managing” underwriter, are there one or two lead underwriters? This term should be limited to the underwriter with primary bookrunning responsibility and, if that cannot be determined, the underwriter with the largest share of bonds to sell. The book-running manager has the best knowledge of the pricing and structure of the bond issue as it evolves during the underwriting process, and would be generating the quantitative analyses as to reinvestment of the bond proceeds. If the test is simply the underwriter named at the top left of the list on the front page of the Official Statement, that test should be clearly stated.
In the last sentence of Treas. Reg. Section 1.148-5(d)(6)(iii)(B)(1), the second time that the word “provider” is used appears to be incorrect and should be changed to the word “person.”

5. **SLGS Comparability Standard.** The comparability standard in Treas. Reg. Section 1.148-5(d)(6)(iii)(C)(2)(ii) requires SLGS to be purchased for a yield restricted defeasance escrow when the cost of the SLGS portfolio is less than the cost of the portfolio of non-SLGS that a state or local government unit intended to purchase for the escrow determined at the time the bids on the non-SLGS are submitted. Because SLGS subscriptions have to be filed five to seven days before settlement, circumstances could arise where failure to satisfy the comparability test, absent an alternative remedy, would result in an inability to complete a contemplated financing. In such circumstances, similar to Rev. Proc. 95-47, 1995-2 C.B. 417, a special yield reduction payment should be permitted to be made to reduce the yield on the yield restricted defeasance escrow to the applicable yield. Procedures similar to those set forth in Section 4 of Rev. Proc. 95-47 could be made applicable to any such special yield reduction payment.

6. **Payments to Brokers.** Treas. Reg. Section 1.148-5(e)(2)(iv) should be revised to permit a state or local government to recover a reasonable fee actually paid to a broker for services rendered in the situation in which the brokered investment is not purchased because the SLGS comparability test in Treas. Reg. Section 1.148-5(d)(6)(iii)(C)(2)(ii) is not satisfied. In practice, the decision as to whether to use open market securities or SLGS may be a close call. In determining whether open market securities are a better choice than SLGS, it is clearly desirable for a state or local government to use a broker to assist it in making such a decision. Much of the broker’s work will have been completed upon the receipt of the bids - work for which a broker may fairly expect compensation. In such a situation, state and local governments
should not be penalized for trying to obtain the best possible investment portfolio by not permitting them to recover the fee actually paid to the broker.

7. **Reasonableness Of Fees.** The second sentence in Treas. Reg. Section 1.148-5(e)(2)(iv)(A) states that “if” a broker’s fee does not exceed a specified amount it will be deemed reasonable. The proposed regulations provided that “to the extent” that a broker’s fee does not exceed a specified amount it would be deemed to be reasonable. The word “if” in this portion of the final regulations should be changed to the phrase “to the extent that.”

8. **Principal Amount Versus Purchase Price.** The reference in Treas. Reg. Section 1.148-5(e)(2)(iv)(B) to the “initial principal amount” of the investment deposited in a yield restricted defeasance escrow would be more appropriate if it were changed to “initial purchase price.”

**COMMENTS—PROPOSED REGULATIONS**

1. **Fees in Excess of Safe Harbor.** Under Prop. Treas. Reg. Section 1.148-5(e)(2)(iii)(A), a broker’s commission or similar fee is a qualified administrative cost if the fee is reasonable within the meaning of Treas. Reg. Section 1.148-5(e)(2)(i). This general test is immediately followed by a safe harbor. The proposed regulations should not be read to mean that a fee in excess of the safe harbor is unreasonable. However, to avoid this interpretation, the following sentence should be added to Prop. Treas. Reg. Section 1.148-5(e)(2)(iii)(A): “The portion of a fee in excess of the amount determined under Treas. Reg. Section 1.148-5(e)(2)(iii)(B) will not be presumed to be unreasonable, but instead will be subject to the general rule of paragraph (e)(2)(i) of this section.”
2. **Safe Harbor Is Too Small For Small Transactions.** The safe harbor provides that a broker fee that does not exceed the lesser of $25,000 and 20 basis points of the computational base will be a reasonable fee. Simple math indicates that the 20 basis point limitation will apply to any investment that is $12,500,000 or less. For example, with respect to a $2,000,000 investment, the safe harbor fee would be only $4,000. The proposed regulations need to acknowledge that a broker is required to do a certain level of work in any transaction, regardless of its size. The proposed regulations should be revised to provide, for example, that for investments of $12,500,000 or less, the safe harbor is the lesser of $5,000 or 40 basis points, but in no event greater than $25,000. Neither the $5,000 minimum or 40 basis point suggestion is based on an analysis of the broker industry, but are only intended to illustrate a possible approach to distinguishing between smaller and larger transactions.

3. **Safe Harbor Is Too Small For Larger Transactions.** As indicated above, the $25,000 limit becomes applicable when an investment exceeds $12,500,000. On its face, it does not appear reasonable to assume that a broker’s fee with respect to a $12,500,000 transaction should be the same as a broker’s fee for a $125,000,000 transaction. Although the amount of work may not be (and probably is not) ten times greater in the case of the $125,000,000 transaction, it is inconceivable that the amount of work would be the same. The $25,000 limit for investments greater than $12,500,000 should be increased as transactions become larger. Again, without advocating any particular breakpoint or minimum, but to illustrate a concept, the following is suggested: $25,000 for investments up to $50,000,000; $50,000 for investments between $50,000,001 and $100,000,000; and $75,000 for investment in excess of $100,000,000.

4. **Long Term Contracts.** Just as the size of the investment has an impact on the work required of a broker, the length of the investment may also result in more work and
analysis by a broker. Without providing a specific suggestion, consideration should be given as to whether a single, long term contract should be considered as two or more shorter term contracts.

5. **$75,000 Aggregate Limit Should Be Replaced With An Antiabuse Rule or Increased.** Presumably, the $75,000 aggregate limit was imposed to prevent the use of multiple investments for which a separate safe harbor fee could be collected when, from a business standpoint, a single investment would have worked equally as well. The imposition of an aggregate limit may distort the behavior of a state or local government issuer over the life of a 30 or 40 year bond issue. A state or local government may not wish to lock up monies in a fund or account for 30 or 40 years. However, if an issuer chooses to invest monies in a fund in five year increments, the $75,000 aggregate would prevent brokers’ fees in the last 15 or 25 years of a bond issue from being qualified administrative costs. The Department of Treasury should not interfere with the investment decisions of state or local governments in this fashion.

To prevent the artificial creation of multiple investments when a single investment would be appropriate, an antiabuse rule could be provided that would aggregate separate investments of bond proceeds that are made at or about the same time (perhaps within 15 days of each other) if the bond proceeds being invested have similar rebate or yield characteristics. Consideration should also be given to transactions that are treated as a single issue for purposes of Section 103 of the Internal Revenue Code of 1986, but involve multiple issuers.

If the $75,000 aggregate limit is not replaced with an antiabuse rule, it should be increased in a manner similar to that discussed above under “3. Safe Harbor Is Too Small For Larger Transactions.”
6. **GICs Versus Other Investments.** The definition of “computational base” in Prop. Treas. Reg. Section 1.148-5(e)(2)(iii)(B)(2) is different for GICs and “investments (other than guaranteed investment contracts) to be deposited in a yield restricted defeasance escrow.” The definition of computational base should be conformed to whatever decision is made in the final regulations as to when a GIC in a yield restricted defease escrow is to be treated as a GIC or as an “investment in a yield defeasance escrow.”

7. **Computational Base for GICs.** The definition of the computational base for GICs contains the concept of “the amount the issuer reasonably expects as of the issue date” to invest in GICs. If the safe harbor is reworked to deal with sequential investments, it will presumably be necessary to modify the requirement that the computational base be determined as of the issuance date.

8. **Effective Date.** The proposed regulations are proposed to apply to bonds sold on or after the date 90 days after the issuance of the final regulations. For the same reasons as discussed in our comments on the 1998 final regulations, when finalized the proposed regulations should electively apply to investments made after a specified date for previously issued bonds.

**ADDITIONAL OBSERVATIONS**

**Presumption of Arm’s-Length Transaction.**

Neither the final regulations nor the proposed regulations explicitly recognize the standard presumption under general federal tax law principles of an arm’s-length transaction in circumstances in which the municipal issuer has an economic incentive to maximize its return on the investment. These situations would include:
(1) Transactions that are exempt from rebate under the small issuer rebate exception of Section 148(f)(4)(D);

(2) Transactions involving a significant amount of negative arbitrage, such that an increase in the yield on the investment would result in no increase on the amount of rebate that would be due to the IRS (an explicit safe harbor could be created if the negative arbitrage exceeded a percentage or dollar-based limit);

(3) Investments of bond proceeds in a construction fund or project fund that the issuer reasonably expects, at the time of the investment, will be exempt from rebate under one of the spending exemptions of Treas. Reg. § 1.148-7; and

(4) Commingled funds in which a significant portion (10% or more) of the funds are described in (1), (2) or (3).

Under these circumstances, general tax law principles should apply and presume an arm’s-length transaction. The regulations should acknowledge the application of these general tax principles where appropriate.