The following comments 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 were prepared by individual members of the Committee on Tax-Exempt Financing. Principal responsibility was taken by John O. Swendseid. Substantial contributions were made by Michael G. Bailey, David A. Caprera, Carol L. Lew, Linda B. Schakel, Jeremy A. Spector, and Milton S. Wakschlag. These comments were reviewed by William M. Loafman of the Section's Committee on Government Submissions and by George Howell, the Council Director for the Committee on Tax-Exempt Financing.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments, 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 to influence the development or outcome of, the specific subject matter of these comments.

Contact Person:

John O. Swendseid
(775) 323-1980

Date: April 4, 2000

Executive Summary

These comments respond to the specific requests for comments contained in the preamble to the proposed regulations on investment type property promulgated under Section 148 of the Internal Revenue Code of 1986, as amended (the "Code"), as published in the Federal Register on August 25, 1999 (the "Proposed Prepayment Regulations").

First, in response to the Internal Revenue Service's ("Service's") request for comments on the scope of the Proposed Prepayment Regulations, these comments conclude that the scope of the Proposed Prepayment Regulations is appropriate and not broader than intended.

The Service's second request for comments, on whether additional guidance is needed in this area, is then addressed. These comments suggest that additional guidance would be helpful in clarifying that refundings are not prepayments, that a prepayment of a capital charge in certain cases does not give rise to investment type property, and that a prepayment that fixed the price, guaranteed the availability or assured a favorable place of delivery of a commodity or service, or reduced the price of the commodity or service materially more than the investment return would permit, is made for a substantial business purpose other than investment return.
These comments also suggest guidance would be helpful in clarifying when an alternative to making a prepayment will be treated as "commercially reasonable," and in providing a definition of "substantial percentage of persons who are similarly situated" for purposes of the existing regulations. Suggested regulatory language for clarifying these areas is provided. These comments also suggest that the Service provide a general de minimis exception to the prepayment rules.

The situation described in the Service's third request for comments, transactions that involve a prepayment for a supply contract and commodity swap, is then discussed and certain changes in the regulations are suggested to assist in determining when the regulations will apply to these types of transactions.

Finally, these comments respond to the request for comments on the effective date of the final regulations. In general, we recommend that the final regulations not have an effective date that is earlier than the date of publication of final regulations. These comments also strongly discourage retroactivity with respect to any change in the regulations that is more restrictive than what was proposed on August 25, 1999.

1. **Effect of Language in Proposed Regulation**
   
   **Request:** "It is intended that these regulations address only a potential issue created by the City of Columbus [City of Columbus v. Commissioner, 112 F.3rd 1201 (D.C. Cir. 1997)] opinion as noted above. Comments are requested on whether the effect of the changes proposed in this document is broader than intended."
   
   **Comment:** The proposed changes address the potential issue mentioned in the preamble and are not broader than intended. We do not understand the proposal as being an attempt to overturn the City of Columbus opinion, but a clarification on this single potential issue. Our understanding is the basic holding of the City of Columbus case, that a prepayment made to refund or retire a prior debt does not result in "investment type property" is left undisturbed. It would be helpful to indicate in the preamble to the final regulations that except for clarifying the potential issue regarding prepayments made after a contract is entered into, it is not the intent of the regulations to change the result in the City of Columbus case.

2. **Additional Guidance**
   
   **Request:** "Comments are requested on whether additional guidance is needed to clarify other aspects of the investment type property definition. For example, comments are requested whether clarification is needed on which prepayments of an obligation will be treated as a prepayment for property or services that gives rise to investment type property and whether a contract under which property or services are to be provided over time and the payments for property or services are to be made over time gives rise to investment type property when the payment schedule does not match the schedule for the provision of property or services."
   
   **Comment:**
   
   1. **Additional guidance on payments over time in exchange for services over time.** It is possible that payments for property or services made over time could give rise to investment type property when the payment schedule does not match the schedule for the provision of property or services. We believe that the general rule presently articulated in the regulations is sufficient to cover these situations. If a prepayment is made before services or goods are provided, the fact the prepayment is made in installments does not make it more or less a prepayment. As we understand the existing rule, each transaction would be analyzed as follows: Are the payments being made prepayments? If so, is a principal purpose of making the
prepayments to receive an investment return from the time the prepayments are made until the
time the payments otherwise would be made? If so, do either of the exceptions of Treas. Reg.
§1.148-1(e)(2)(i)(A) or (B) apply? If payments are made in installments, for goods or services
delivered in installments, this same analysis would be applied to the entire transaction to
determine whether "investment type property" was present.
2. Other Guidance. The Committee believes additional guidance would be helpful. As the
Service is aware, in rendering opinions on the tax status of tax exempt bonds, bond counsel
is almost always required to render an "unqualified" opinion. As a result of this high
standard, even hints that the Service may disagree with some conclusions in this area often
have a chilling effect on the ability of counsel to render these opinions and on the bond
market. (An example of this chilling effect is the adverse effect on the market for certain
bonds that these very Proposed Prepayment Regulations had. This occurred even though
the Proposed Prepayment Regulations are not yet effective, because of the lack of clarity in
the regulations and certain statements in the preamble and the ambiguity in the proposed
effective date.) The Committee suggests the Service provide additional guidance to
practitioners and their clients so that they can engage in transactions that involve
prepayments that are not abusive. Without better guidance, given the high standard of bond
counsel opinions, legitimate transactions may be thwarted.
1. Prepayments vs. Refundings. As we understand the law, a refunding is not a
prepayment for property or services, even though it does amount to an early payment.
See the Tax Court's decision on remand in City of Columbus v. Commissioner, T.C.
prepaying the remaining obligations, extinguished its preceding debt... [W]e do not
think it was paying for property.... Since there is no prepayment for property, we hold
the prepayment, in and of itself, does not constitute investment type property.") It would
be helpful for the regulation to specifically state that a prepayment of an existing
debt prior to the due date thereof, does not, in and of itself, give rise to investment type
property. Such a regulation could go on to say that if the refunded obligation was
issued to make a prepayment for property that gave rise to "investment type property,"
this investment type property would transfer to the refunding bonds in accordance with
the transferred proceeds rules. If this suggestion is accepted, the following language
could be added at the end of Treas. Reg. §1.148-1(e)(2)(i):
For purposes of this paragraph (2)(i), a prepayment or refunding of an existing
debt is not a prepayment that creates investment type property; however, if the
debt was used to make a prepayment for property that gave rise to investment
type property under the regulations in effect at the time the refunded debt was
issued, that investment type property may transfer to the refunding bonds in
accordance with the transferred proceeds rules of §1.148-9.
2. Prepayments of Capital Charges. Tax exempt bond issuers that own utilities frequently
purchase all or a portion of the commodity being furnished (water, power, gas) on a
wholesale basis and sell this commodity on a retail basis to their residents and other
customers. Many times, the price paid for the commodity will include a capital charge,
representing a return of all or a portion of the seller's capital investment in the plant or
other asset furnishing the commodity. Bond issuers are sometimes offered the
opportunity to prepay the capital charge and thereby save considerable money as the
seller does not need to earn an investment return on the amount being prepaid.
For example, City A may have a long term contract agreement with Government
Agency B whereby Government Agency B will deliver to City A water from a water
storage project over a period of years. In exchange, City A will pay for that water an
amount equal to Government Agency B's ongoing cost of the water plus a capital
charge that is determined based on Government Agency B’s capital investment in the water storage project and a rate of return on that investment. If Government Agency B is willing to accept a lump sum payment of the capital component of the charges under this contract in exchange for ceasing to charge the principal and interest component of the capital charge, this lump sum payment ought not to be treated as a prepayment for property that constitutes investment property, but should be treated as a reimbursement of the seller’s capital costs. We understand that the Internal Revenue Service may not desire to treat a lump sum prepayment in this manner where that lump sum is a reimbursement for the cost of intangible financial assets; however, in many of these contracts the capital charge payments do not involve intangible financial assets at all, but involve an original investment in “bricks and mortar” e.g. the water storage project in the above example. To clarify this treatment, we would suggest a new exception be added to Treas. Reg. §1.148-1(e)(1)(2)(i) as follows:

(C) the prepayment is in substance a payment for all or a portion of the capital costs of a specific project previously incurred by the recipient of the prepayment. A prepayment of all or a portion of amounts due under a contract pursuant to which a service or commodity is delivered over time will be treated as a payment for capital costs of a specific project if making the prepayment will cause the interest component, if any, with respect to the capital charges being prepaid to cease, and if the prepayment is made to wholly or partially reimburse the person receiving the prepayment for its capital investment in the project through which or by the use of which the service or commodity is produced or delivered. For purposes of the preceding sentence, "capital investment" means an investment which consists primarily of the cost of the acquisition of real property or the construction or acquisition of improvements to real property or tangible personal property, or a combination thereof.

Such a regulation would codify the Service’s conclusion in Private Letter Ruling 9142012 which involved a prepayment of a "capacity" charge in connection with a contract to furnish electricity.

3. "Substantial Business Purpose." Practitioners would also like to make it clear that generally a prepayment for a commodity or service is made for a "substantial business purpose" other than investment return when the effect of the prepayment is to fix the price of the service or commodity (which otherwise may be volatile or unpredictable), to assure a supply of the service or commodity (which otherwise might not be available), to guarantee delivery of the service or commodity at a location favorable to the issuer (which might not otherwise be assured) or to obtain a price discount that materially exceeds the investment return. Thus, if in exchange for making a prepayment for computer software support, a municipality was guaranteed a specific number of hours of computer support at such times, or at such computing locations as the municipality desired, or the municipality was guaranteed a specified price for that support, the Internal Revenue Service should treat this prepayment as being made for a substantial business purpose other than investment return (namely to fix the price, to assure the supply, or to guarantee a favorable place of delivery). Also, a prepayment that results in a reduction in the price of the goods or services to be delivered in the future that materially exceeds the investment return that could be earned (assuming a reasonable taxable interest rate) between the time the prepayment is made and the time goods or services are delivered, is a prepayment made for a "substantial business purpose" other than investment return, namely to obtain that reduction in price.
It is worth noting that in certain situations, a service or commodity provider may be
ing willing to offer a substantially lower price in exchange for a prepayment for a variety of
reasons unrelated to the investment return that could be earned on the prepayment.
For example, the prepayment eliminates credit risk from the provider's viewpoint and
also guarantees to the provider a market for the quantity of goods/services being
prepaid. If, as a result of these or other non-investment factors, the provider gives the
issuer a prepayment discount that materially exceeds any possible investment return,
the issuer ought to be able to take advantage of this offer. With respect to this
suggestion, a safe harbor would be helpful in identifying when a price discount
"materially" exceeds the possible investment return. Such a safe harbor is contained in
the proposed change to the Proposed Prepayment Regulations set out below.

The suggestions described above could be accomplished by adding at the end of
paragraph 2(i) of Treas. Reg. §1.148-1(e) the following:

For the purpose of clause (A) of this paragraph 2(i), a prepayment will be
treated as made for substantial business purposes other than investment return
if a principal purpose for the prepayment is obtaining a guaranteed fixed price
for goods or services to be delivered in the future, obtaining a guaranteed
supply of goods or services to be delivered in the future, obtaining a guaranteed
favorable place of delivery of goods or services to be delivered in the future, or
obtaining a price discount that materially exceeds the investment return on the
prepayment from the date it is made until the date the goods or services are
delivered. As a safe harbor, a price discount will be deemed to materially
exceed the benefit from investment return on the prepayment if the present
value of the price discount exceeds by more than 25% the present value of the
investment return (computed at a reasonable taxable interest rate) attributable
to the prepayment from the time the prepayment is made until the time the
goods or services are delivered. For this purpose, a "reasonable taxable interest
rate" is a taxable interest rate at which the entity receiving the prepayment could
borrow money on reasonable terms for a period comparable to the period
between the time the prepayment is made and the time the goods or services are
delivered, and present value shall be calculated using the interest rate on
treasury obligations of a duration similar to the period of time from the date the
prepayment is made until the date the goods or services are delivered as the
discount rate.

4. "Commercially Reasonable" Alternatives. Further guidance is needed to determine
whether an alternative is "commercially reasonable." We believe that an alternative
should be viewed as commercially reasonable if the alternative is reasonably available
to the issuer, it would achieve the same substantial business purpose as the
prepayment except that no investment return is received, and it is not more expensive
by an amount that materially exceeds the investment return on the prepayment. For
example, if an issuer is considering making a prepayment for the substantial business
purpose of guaranteeing the price of a service or commodity and the issuer could
obtain a guaranteed price for a service or commodity by either: (i) making a
prepayment; or by (ii) entering into a "future delivery/future pay" contract (that provides
for fixed payments at fixed times in the future contemporaneously with delivery of the
service or commodity), and the only difference between these two alternatives is that
the prepayment is a lower total dollar price because of the investment return between
the time the prepayment is made and the time the commodity is delivered, the "future
delivery/future pay" contract would be a "commercially reasonable" alternative.
If, however, either a guaranteed fixed price for the commodity or service was not reasonably available without a prepayment, or if the difference in dollar price between the alternative and the prepayment (adjusted to present value) is materially more than the investment return that could be earned between the time the prepayment is made and the time the commodity is delivered, the issuer would be viewed as having no "commercially reasonable" alternative. In the latter case, the committee also suggests that the regulations provide a safe harbor as to when an alternative is sufficiently more costly to be regarded as not being "commercially reasonable."

If these suggestions are accepted, they could be implemented by adding the following language at the end of Treas. Reg. §1.148-1(e)(2)(i):

For purposes of clause (A) of this paragraph 2(i), an alternative is not "commercially reasonable" if it is not reasonably available to the issuer or if it will not achieve the same substantial business purposes as the prepayment would achieve except the benefit of the investment return on the prepayment from the time the prepayment is made until the time the goods or services that are the subject of the prepayment are delivered. In addition, if the present value cost of an alternative that achieves the same substantial business purpose as the prepayment exceeds the present value of the cost of the prepayment by an amount that is materially more than the investment return (computed at a reasonable taxable interest rate) attributable to the prepayment from the time the prepayment is made until the time the goods or services are delivered, the alternative is not treated as being a commercially reasonable alternative to making the prepayment. As a safe harbor, if the present value of the cost of an alternative exceeds the present value of the cost of the prepayment by an amount that is at least 25% more than the present value of the investment return (computed at a reasonable taxable interest rate) attributable to the prepayment from the time the prepayment is made until the time the goods or services are delivered, the alternative need not be treated as being "commercially reasonable." For this purpose, a "reasonable taxable interest rate" is a taxable interest rate at which the entity receiving the prepayment could borrow money on reasonable terms for a period comparable to the period between the time the prepayment is made and the time the goods or services are delivered, and present value shall be calculated using the interest rate on treasury obligations of a duration similar to the period of time from the date the prepayment is made until the date the goods or services are delivered as the discount rate.

5. "Substantial Percentage" of Persons. Guidance is also needed in meeting the "substantial percentage of persons" test in Treas. Reg. §1.148-1(e)(2)(1)(B). Frequently, issuers will not know how many persons are "similarly situated," so that calculation of a percentage is difficult or impossible. (In some situations, the number of persons "similarly situated" is small and may be known to the issuer - as was the case in the City of Columbus decision; however, it is much more difficult to determine how many persons are "similarly situated" in the case of energy, commodity and service prepayments). To make this test easier to administer for issuers and the Service, we would suggest that if a substantial number of persons similarly situated who are not beneficiaries of tax exempt financing make a similarly sized prepayment, there ought not be a requirement to determine the total number of persons similarly situated in order to calculate a percentage.
Also, we suggest that a safe harbor be added providing that if the issuer and service or commodity provider certify reasonably and in good faith that either 25% (by analogy to the definition of "Substantial Improvement" in Section 42(d)(2)(D)(i)(III) of the Code) of the "similarly situated" persons who are not beneficiaries of tax exempt bonds, or 25 or more "similarly situated" unrelated persons who are not beneficiaries of tax exempt bonds make prepayments in a similar or larger size on substantially the same terms, the issuer will be deemed to meet this test. If this suggestion is accepted, it could be implemented by rewriting Treas. Reg. 1.148-1(e)(2)(i)(B) to read as follows:

(B) Prepayments on substantially the same terms and in similar or larger amounts are made from a source other than a tax exempt borrowing by either a substantial percentage of similarly situated persons or a substantial number of similarly situated persons. As a safe harbor, this test will be deemed to be met if the issuer of the bonds and service or commodity provider to whom the prepayment is made reasonably and in good faith certify (i) that at least 25% of the similarly situated persons who are not beneficiaries of tax exempt bonds have made prepayments in similar or larger amounts on substantially the same terms, or (ii) that at least 25 unrelated persons who are not beneficiaries of the tax exempt bonds have made prepayments in similar or larger amounts on substantially the same terms.

6. **De Minimis.** Prepayments of small amounts, or for a short time should be disregarded, to save issuers and the Service the time of examining these transactions. We suggest that prepayments that do not exceed the lesser of $100,000 or 10% of the proceeds of an issue be disregarded, as well as any prepayments made within 90 days prior to the date the goods or services are delivered. If this suggestion is accepted, new clauses "(C)" and "(D)" could be added after Treas. Reg. §1.148-1(e)(2)(i)(B) to read as follows:

(C) The amount of prepayments made with proceeds of an issue does not exceed the lesser of 10% of the proceeds of the issue or $100,000

or

(D) The prepayment is made within 90 days of the expected delivery date of the goods or services whose cost is being prepaid.

3. **Supply Contract/Swap Transactions**

Request: The preamble also asks for comments on situations where the issuer issues bonds to prepay for commodities to be delivered to the issuer pursuant to a long term supply contract at a fixed price over a number of years and the issuer also enters into other arrangements including one or more swap agreements that result in the issuer converting substantially all of the issuer's costs for the commodity under the long term supply contract into a variable cost that approximates the then current price of the commodity when the issuer takes delivery.

Comment: We recognize the Service's concern in this area. We believe, however, this could be adequately analyzed under the existing regulations, so long as in judging the "substantial business purpose" and whether there are "commercially reasonable alternatives," all relevant facts and circumstances, including related transactions such as the swap in this example are taken into account.

To clarify applicability of the regulations in a situation like that described in the example in the preamble an explicit statement could be made in the regulations to the effect that in
judging the "principal purpose for prepaying," "substantial business purpose" and "commercially reasonable alternatives," any and all relevant facts and circumstances, including any related transactions are taken into account. If the suggestion is accepted, however, we also believe that a statement to the effect that transactions involving the service or commodity for which the prepayment is made which are not entered into as part of the same transaction as the prepayment and which are entered into for reasons independent of investment return, should be disregarded. Additionally, a safe harbor period separating the prepayment from other transactions (e.g., 6 months by analogy to the 6 month period for non-integration of asset acquisitions with refundings described in Treas. Reg. 1.150-1(d)(2)(v)) would be helpful. If these suggestions are accepted, they could be implemented by adding the following text at the end of clause (i) of Treas. Reg. §1.148-1(e)(2) after the suggestions described above:

In determining the principal purpose of a prepayment, whether there is a substantial business purpose other than investment return and whether there are commercially reasonable alternatives, all relevant facts and circumstances will be taken into account, including any related transaction involving the service or commodity for which the prepayment is made. A transaction involving the commodity or service for which the prepayment was made, which is not entered into as part of the same transaction as the prepayment and which is entered into for a substantial business purpose that is independent of any investment return achieved from the two transactions, is not a related transaction for purposes of the foregoing sentence. For this purpose, any transaction which is entered into 6 months or more before or after the prepayment is made shall not be treated as a related transaction.

4. **Effective Date**

Request: "Treasury and the IRS request comment as to the date of applicability of the final regulations." The preamble suggests this applicability will not be before August 25, 1999.

Comment: We recommend that the Service not promulgate the final regulations with a retroactive effective date. In fairness to taxpayers and bond issuers and in keeping with the common meaning of "proposed," the final regulations should have an effective date not earlier than the promulgation of those final regulations.

The Committee strongly objects to the idea that final regulations may be promulgated that differ in a restrictive way from the Proposed Prepayment Regulations with an effective date prior to the time those final regulations are published. This kind of retroactive rule making, without prior notice of the contents of the retroactive regulation, is fundamentally unfair. The hints in the preamble that such an approach might be taken have already disrupted the market for some types of bonds.

We note that Congress has expressed to the Service a policy of not engaging in this type of retroactive rulemaking by enacting §7805(b) of the Code. While this provision may technically not apply here (because the Proposed Prepayment Regulations related to a Code provision enacted before June 30, 1996) the Committee believes Congress' adoption of §7805(b) reflects a policy of fairness and the "rule of law" — i.e., taxpayers and issuers taking an action should only have the comply with the laws and regulations in existence in writing at the time the action is taken.

We recommend that the Service not provide an effective date for final regulations that is earlier than the date of publication of those final regulations. In particular, however, if the final regulations depart, in any restrictive way, from the regulations that were proposed on
August 25, 1999, we strongly urge the Service to provide an effective date that is on or after the date of publication of those final regulations.