Comments on Notice of Proposed Rule Making – Arbitrage and Related Restrictions Applicable to Tax-Exempt Bonds issued by State and Local Governments

Investment-Type Property (Prepayment); Private Loan (Prepayment)

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 Jeffrey Berry, Frederic Ballard, James R. Eustis, Carol Lew, Lawrence Salva, and Jeremy Spector. These comments were reviewed by Dean Weiner of the Section’s Committee on Government Submissions and by Stevie D. Conlon, 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.

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Comments on Proposed Regulations on Prepayments
(Prop. Treas. Reg. §1.148-1(e); Prop. Treas. Reg. §1.141-5(c)(2)(ii))

These are the comments of individual members of the American Bar Association's Section of Taxation, Committee on Tax Exempt Obligations (the "Committee") on the proposed regulations dealing with prepayments under Sections 148 and 141 of the Internal Revenue Code of 1986 (the "Code") which were published in the Federal Register on Wednesday, April 17, 2002. As a matter of convenience, these comments are made to Prop. Treas. Reg. §1.148-1(e)(2). Identical comments are also made to Prop. Treas. Reg. §1.141-5(c)(2)(ii).

1. "Substantial Business Purpose." Prop. Treas. Reg. §1.148-1(e)(2) proposes a general rule that a prepayment gives rise to investment-type property if a principal purpose for the prepayment is to receive an investment return from the time the prepayment is made until the time the payment otherwise would have been made. There are four prepayment situations described in Prop. Treas. Reg. §1.148(e)(2)(ii)(A) to (D) that the regulation indicates do not give rise to investment type property (herein "Permitted Prepayments"). The first Permitted Prepayment situation applies when:

   The primary purpose for the prepayment is to accomplish one or more substantial business purposes that

   (1) Are unrelated to any investment return based on the time value of money and

   (2) that cannot be accomplished without the prepayment.

(emphasis added). The existing regulation has a somewhat similar provision which allows a prepayment to be made if the prepayment is

made for a substantial business purpose other than the investment return and
the issuer has no commercially reasonable alternative to the prepayment.


The language of the existing regulation, which requires that there be no "commercially reasonable" alternative to making the prepayment, is superior to the new language which seems to indicate there must be no alternative to making the prepayment, whether it is a reasonable alternative or not. The implication of the new language is that an issuer must take any action it can to avoid a prepayment, including commercially unreasonable action.

Allowing this Permitted Prepayment to be used only when there is "no alternative" eliminates the usefulness of this Permitted Payment guidance for bond issuers as well as for the IRS, as there likely very are few situations where there are literally "no alternatives" to making the prepayment.
Further, we believe that the new language arguably does not comport with Congress' intent. Proposed Treas. Reg. §1.148-1(e)(2) is meant to implement Congress' addition of new types of investment property subject to the arbitrage regulations in the 1986 Code. The 1986 Code provision added "annuities" and "other investment type property" to the types of property that are subject to arbitrage restrictions. (See IRC §148(a)(2)(C)&(D)). The legislative history indicates that Congress' intent was to expand the arbitrage restrictions "to apply to the acquisition of any property held for investment other than another [tax exempt bond]" (emphasis added). (Conference report to accompany Tax Reform Act of 1986, H. Rep. No. 99-841, Vol. II, p. ii-747.) This indicates Congress wanted to regulate – subject to arbitrage regulations - property "held for investment." The second part of the test in the new regulation, requiring that there be no alternative to making the prepayment, arguably goes beyond this intent, as it subjects prepayments to arbitrage restrictions even where the prepayment is made for a substantial business purpose unrelated to investment return.

Finally, the new regulation language seems inconsistent with Example 2 in Prop. Treas. Reg. §1.148-1(e)(2)(iv), which is designed to be an example of this first type of Permitted Prepayment. The example leads one to believe that the purpose of the prepayment could be accomplished without a prepayment, but accomplishing this purpose without a prepayment would have been much more expensive for the buyer and seller. If the purpose could be accomplished without a prepayment, however, under the words of the regulation itself, this "Permitted Prepayment" exception is not available. Language requiring only that there not be a "commercially reasonable" alternative to making the prepayment, is more consistent with the example than the proposed language of the regulation.

2. "Customary." The second Permitted Prepayment in the proposed regulations applies if

(b) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax exempt financing.

As was pointed out in earlier comments we submitted, it is very difficult to determine what a "substantial percentage" means, and even more difficult to determine, as a factual matter, what this "substantial percentage" of persons are doing, i.e., are they prepaying for particular goods and services or not? Given this state of affairs, it would be very helpful if the regulations contained some examples of these "customary" prepayments. Issuers could then make these types of prepayments without having to determine what a substantial percentage of persons who do not benefit from tax exempt bonds are doing. Examples might include payments for bond insurance; prepaid maintenance and repair contracts and extended warranty contracts for personal property (automobiles; electronic equipment, etc.); and prepaid software update and software service contracts (frequently offered at the time the software is sold or installed).

3. De minimis Exception. The third Permitted Prepayment is one which:
is made within 90 days of the date of delivery to the issuer of all of the property or services for which the prepayment is made.

(emphasis added). This Permitted Prepayment is welcome. However, we believe this Permitted Prepayment should be slightly altered to apply if the payment "is made within 90 days of the reasonably expected date of delivery of all of the property or services for which the prepayment is made." This way, a glitch (e.g., transportation problems or a mistake by the vendor) which results in not all of the property or services being delivered within exactly 90 days would not cause a tax problem for bondholders.

4. Natural Gas - Applied to Other "Output" Services. The proposed regulation has a fourth Permitted Prepayment that applies to prepayments to acquire a supply of natural gas that is either retailed to consumers of the municipal utility acquiring the gas or is used to produce electricity that is retailed to consumers of a municipal utility. Other commodities acquired by government for resale are not economically different than natural gas and ought to be treated in the same way. For example, municipal electric utilities have many of the same deregulation related supply problems as municipal gas utilities. These utilities ought to be treated the same way as municipal natural gas utilities and should be entitled to make prepayments for the commodity that is delivered to their wholesale or retail customers subject to similar rules to those applicable to natural gas. Indeed, a good place to draw this line may be that the special provisions that now apply only to natural gas should apply to any commodity or service furnished through an "output" facility, which would then include electricity, water and other similar services. The IRS and Congress have for a substantial period of time, provided special treatment for output facilities. (See, e.g., IRC §§141(b)(4), 141(d); Treas. Regs. §§1.141-7T, 1.141-8T, former Treas. Reg. §1.103-7(b)(5)). This is another area where this special treatment should be continued.

5. Natural Gas - Specific Comments on Regulations.

A. 95% Test. A part of the natural gas regulation is that at least 95% of the natural gas purchased with the prepayment "is to be consumed by retail gas customers in the service area . . . of a municipal utility, or used to produce electricity that will be furnished to retail electric customers that a municipal utility is obligated to serve under state or Federal law." Prop. Treas. Reg. §1.148-1(e)(2)(ii)(A)(2). Natural gas consumption varies considerably with the weather from year to year. Thus, if a utility entered into 5 prepayment contracts for an identical supply of natural gas designed to fit that utility’s needs for natural gas in each of the subsequent 5 years, it is very likely that in one or more of those years, if there was warm weather, all of the natural gas would not be needed. Changing weather patterns (e.g., global warming) and other factors make it impossible to predict accurately - - within 5% - - how much natural gas is needed.

One suggestion for alleviating this problem would be to base the 95% test on the municipal utility’s reasonable expectations (perhaps certified by an expert) as to the amount of gas the municipal utility will need during the period the gas purchased with the prepayment will be used.
Under this proposal, if it happens that there are several hot years where all the natural gas is not consumed, bonds issued to acquire the natural gas would not become taxable so long as at the time the gas prepayment contract was executed the amount of gas being purchased was reasonable. An alternative approach to this problem, we believe, would be to require that the amount of gas purchased be based on expected demand and to impose requirements on the disposition of any gas purchased in excess of the municipality’s needs – e.g., allow sales of surplus gas acquired with the prepayment only on a short term or spot basis if the forecast demand is not achieved. Here, the Service could use the same approach as that used for other output financings, such as Treas. Reg. §1.141-7T(f)(1) to (3).

B. "Obligated to Serve." The requirement of the regulation that natural gas used to produce electricity has to be used to produce electricity that is furnished to retail electric customers that a municipality is "obligated to serve" under state and federal law does not work well in many jurisdictions. In several states with which we are familiar, municipal utilities have no state or federal "obligation to serve." Rather, in these states, municipalities have the power to provide electricity to retail customers, but no obligation to do so. Many municipalities have chosen to exercise this power and have a large number of retail electric customers; however, these utilities are under no state or federal obligation to serve. Consequently, we recommend that the requirement that electric customers be ones which a municipality is "obligated to serve" under state or federal law should be deleted.

6. Example 2. We believe that some clarification is needed as to Example 2, which contains several facts that in our view do not seem relevant to the determination of whether the primary purpose for the prepayment is to accomplish one or more substantial business purposes that are unrelated to investment return and could not be accomplished without the prepayment. For example, why is it relevant to this question that the power company receiving the prepayment took the prepayment into account as income for federal income tax purposes? If the Service means to make that a requirement (i.e., that a prepayment is permitted under paragraph (e)(2)(i)(A) only if the party receiving the prepayment takes the prepayment into account as income), that should be stated as part of the regulation; but what the receiver of the prepayment does with the prepayment, or how it is treated on the receiver's books for federal income tax purposes, should not have anything to do with whether or not the prepayment is property "held for investment" by the payer of the prepayment. We recommend that this fact, and any other facts that are not relevant to determining whether the language of the regulation is met should be deleted from this example.