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Hon. Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Proposed Regulations under Section 148

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 148. These comments represent the views 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,

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department
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**RECOMMENDATION TO MODIFY YIELD REDUCTION PAYMENT PROVISIONS
IN SECTION 1.148-5(c) OF THE TREASURY REGULATIONS WITH RESPECT TO
ADVANCE REFUNDING ESCROWS FUNDED WITH PROCEEDS OF HEDGED
BONDS**

This recommendation is submitted on behalf of the American Bar Association Section of Taxation and has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, this recommendation should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing this recommendation was exercised by Scott R. Lilienthal, Chair of the Tax Exempt Financing Committee's Subcommittee on Arbitrage, and Clifford M. Gerber, Chair of the Tax Exempt Financing Committee. Substantive contributions to this recommendation were made by Michael G. Bailey, Vice Chair of the Tax Exempt Financing Committee. This recommendation was reviewed by David A. Caprera of the Section's Committee on Government Submissions and by Peter J. Connors, the Council Director for the Tax Exempt Financing Committee.

Although members of the Section of Taxation who participated in preparing this recommendation have clients that would be affected by the federal tax rules applicable to the subject matter addressed by this recommendation or have advised on the application of such rules, 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 matter of this recommendation.

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Dated: April 12, 2006

EXECUTIVE SUMMARY

The arbitrage provisions of Section 148 of the Internal Revenue Code of 1986, as amended (the “Code”) generally provide that proceeds of an issue of tax-exempt bonds to be used to advance refund a prior issue must be invested at a yield not exceeding the yield on the refunding issue. Moreover, Treasury Regulations issued under Section 148 provide that the yield on an issue of bonds may be computed by taking into account both the payments on the bonds and payments made or received under a “qualified hedge” entered into by the issuer, such as an interest rate swap. The Treasury Regulations further permit issuers to effectively restrict the yield on investments of bond proceeds by making “yield reduction payments” to the IRS, but the rules specifically prohibit the use of such payments in connection with proceeds of advance refunding issues. In order to simplify compliance with arbitrage yield restriction, this report recommends that the Treasury Regulations under Section 148 of the Code be modified to permit issuers to make yield reduction payments with respect to investments made with proceeds of variable rate advance refunding issues where the issuer has entered into a qualified hedge. This modification will allow issuers to avoid various complex financing structures currently being used to comply with yield restriction in this situation, while ensuring that any arbitrage profits are properly paid to the IRS. This report also recommends, in the alternative, that the restriction on the use of yield reduction payments with respect to advance refunding issues be eliminated in its entirety.

I. INTRODUCTION

The Priority Guidance Plan of the Treasury Department for Fiscal Year 2004-2005 included an item under the general category of “Tax-Exempt Bonds” entitled “Guidance on LIBOR-based swap transactions.” Our understanding is that this item was intended in part to provide guidance regarding whether, and under what circumstances, an issue of variable rate tax-exempt bonds hedged by an interest rate swap the variable payments under which are based on an interest index derived from the taxable debt market, such as the London Interbank Offer Rate (“LIBOR”), may qualify for treatment as a “fixed yield issue” under the “super-integration” rules of Section 1.148-4(h)(4) of the Treasury Regulations. As described in greater detail below, the issue of “super-integration” is particularly important in the context of an advance refunding issue because (1) proceeds deposited in an advance refunding escrow generally must be invested at a yield that does not exceed the yield on the advance refunding issue; (2) in order to accomplish a legal defeasance of the bonds being refunded, the investments in the advance refunding escrow must generally be fixed and determinable on the date of issuance of the advance refunding issue; and (3) the ability to super-integrate allows the yield on the advance refunding issue to be determined once, at the time of issuance of the advance refunding issue,¹ enabling an issuer to assure compliance with (1) above. Without explanation for its deletion, this item was not included in the Priority Guidance Plan of the Treasury Department for Fiscal Year 2005-2006.²

We are nonetheless optimistic that the Treasury Department will continue to explore the issue of super-integration. We are also optimistic that the product of such consideration will ultimately be a set of rules with standards that prove workable by the municipal bond industry and that also provide sufficient safeguards as to provide the Treasury Department with a level of comfort that the possibility of manipulation by those employing the rules in connection with their interest rate swaps is minimized.³ Until that time, many in the industry utilizing swaps in connection with tax-exempt bonds will proceed under the framework

¹ Under Section 1.148-4(b)(1)(i) of the Treasury Regulations, the yield on a fixed yield issue is determined upon its issuance and is not subsequently redetermined except upon the transfer, waiver or modification of a right that is part of the terms of the bonds or upon the termination of a qualified hedge with respect to the fixed yield issue.

² On August 8, 2005, the Treasury Department released the 2005-2006 Priority Guidance Plan, listing 254 projects for the plan year beginning July 1, 2005, and ending June 30, 2006. On March 6, 2006, the Treasury Department released its first periodic update to that plan, adding 58 items of additional guidance. The “Guidance on LIBOR-based swap transactions” item was not included in the original August 2005 plan, nor was it re-included with the March 2006 plan update.

³ The scope of this submission is limited to recommending a remedy to address the obstacles issuers face in achieving yield compliance when they cannot avail themselves of super-integration and fixed yield treatment. Nonetheless, we wish to emphasize that there is no reason to conclude that super-integration of LIBOR-based swaps is inconsistent with the purposes of Section 148 of the Code. Indeed, super-integration of LIBOR-based swaps frequently results in lower bond yields than super-integration of comparable swaps based on the Bond Market Association (“BMA”) Municipal Swap Index-based swaps. In addition, the regime for identification of qualified hedges under Section 1.148-4(h) of the Treasury Regulations is primarily elective, but issuers must identify a hedge as a qualified hedge when the hedge is entered into and not based on hindsight. Thus, any uncertainty regarding whether a hedge is properly super-integrated is not consistent with the basic approach of the regulations requiring an up-front election.

of “basic” integration (described below) in which the bond issue, though economically fixed as a result of the swap (subject to “basis risk,” described below), continues legally to be treated as a variable yield issue, making yield compliance more complex and difficult for an issuer, its counsel and its financial advisor. It is in this light that we submit the recommendation contained herein.

II. BACKGROUND AND BASIS OF PROPOSAL

A. Basic Integration

The relevant rules governing the treatment of qualified hedges under the arbitrage rules are contained in Section 1.148-4(h) of the Treasury Regulations. Section 1.148-4(h)(1) of the Treasury Regulations⁴ provides: “Payments made or received by an issuer under a qualified hedge (as defined in paragraph (h)(2) of this section) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue.” Thus, if an instrument is a qualified hedge, as defined in Section 1.148-4(h)(2),⁵ then it is effectively integrated with the bond issue to which it relates for purposes of computing the yield on the bond issue for purposes of the arbitrage rules of Code Section 148. Treatment of a qualified hedge under Sections 1.148-4(h)(1) and (h)(2) is commonly referred to as “basic” integration.

A typical use of the qualified hedge rules of Section 1.148-4(h) involves the issuance of variable rate bonds, accompanied by the issuer’s entering into an interest rate swap with a notional principal amount equal to the principal amount of the bonds, under which the issuer makes payments based on a fixed rate and receives payments based on a variable rate intended to equal or approximate the variable rate on the bonds.⁶ Viewing the bonds and swap together, the issuer effectively creates a fixed rate obligation for the period covered by the swap, subject to any variation between the variable rate on the bonds and the variable rate used in the swap, commonly referred to as “basis risk.”

Most variable rate bonds issued in the municipal market bear interest at a rate that is set either by a remarketing agent or through an auction process, which in either case is intended to produce an interest rate at which the bonds will trade at 100% of their stated principal amount as of the date of the determination.⁷ In contrast, the variable rate on most

⁴ Unless otherwise indicated, section references hereinafter made are to the Treasury Regulations.

⁵ Section 1.148-4(h)(2) contains eight separate requirements, each of which must be met for a hedge, including an interest rate swap, to be treated as a “qualified hedge.” Section 1.148-4(h)(5) contains several additional requirements to be met when the hedge is entered into prior to the issue date of the hedged bond. A detailed discussion of these requirements is beyond the scope of this submission.

⁶ Payments on the swap are typically netted, so that on any given payment date the party obligated to make the larger payment pays the net amount due to the other party.

⁷ Most variable rate municipal debt, whether tender bonds or auction rate securities, is credit enhanced, so that a variable rate bond issue typically trades based on the credit of the credit enhancer, whether a bond insurer or a letter of credit bank. Even when a bond issue has liquidity support and no credit enhancement, the bonds still tend to trade based in large part on the bank’s credit since bondholders have the right, upon short notice,

interest rate swaps is based on an interest rate index, *e.g.*, the Bond Market Association Municipal Swap Index (“BMA”) or a percentage of LIBOR, which is the more commonly used index. The BMA index is based on the current rate for high-grade 7-day tax-exempt paper, while LIBOR is an average of the interest rate on dollar-denominated deposits traded between banks in London. While BMA is derived from the tax-exempt municipal market, LIBOR is derived from the taxable debt market. Swap counterparties are more inclined to do transactions using LIBOR because it exists in a significantly larger and much more liquid market than does BMA. Additionally, using LIBOR as an index shifts so-called “tax risk”⁸ away from the swap counterparty and to the municipal issuer. For these reasons, issuers generally are able to obtain a significantly better rate from swap counterparties on the fixed leg of a swap using LIBOR.

If the swap meets the various rules of Section 1.148-4(h)(2) so as to qualify for basic integration, payments made or received by the issuer under the swap are to be taken into account in calculating the yield on the bonds. The bonds, however, remain a variable yield issue for all purposes of Section 148 of the Code (unless the bonds meet the additional requirements for super-integration). This is so even if the swap covers the entire term of the bonds. Accordingly, on the issue date of the bonds, an issuer will not know with certainty the yield on the bond issue for purposes of Section 148 of the Code. While this is not a problem for many bond issues, there are certain bond issues for which a precise determination of yield is very important, the most common of which is an advance refunding. Proceeds of an advance refunding are used to establish a defeasance escrow that must be invested at a yield that does not exceed the yield on the refunding issue by more than 0.001%.⁹ Since the investments in the escrow generally must be purchased on the date the refunding bonds are issued, it is crucial for the issuer to know the yield at which the escrow may be invested.

B. Super-Integration

In order to provide issuers with certainty in yield calculations (such as for advance refundings), Section 1.148-4(h)(4) of the Treasury Regulations provides that certain variable rate bonds may be treated as a fixed yield issue for purposes of Section 148 of the Code if there is a qualified hedge that meets three additional requirements set forth in Section 1.148-4(h)(4)(i). Treatment of a qualified hedge under Section 1.148-4(h)(4) is commonly referred to

to tender their bonds to the bank. In infrequent cases, most notably uninsured auction rate debt, there is no bank or insurer involved, and the bonds trade exclusively on the basis of the issuer’s own credit.

⁸ “Tax risk” in this context means the risk that the top marginal income tax rate will fall and that, as a result, the value of the tax exemption of municipal bonds to a holder will decline such that holders will require a higher interest rate on municipal bonds. The effect of such higher interest rate is a “compression” of tax-exempt and taxable rates, which typically occurs at the longer end of the yield curve. In the context of a swap already in place, an issuer could find itself in the position of having the interest rate on its variable rate obligations increase while it receives no increase in payments under a LIBOR-based swap. In a BMA-based swap, on the other hand, that index would increase as well as a result of a change in the top marginal income tax rate, so that an issuer’s risk of being short on its bond interest payments being paid from its hedge is minimized.

⁹ Because this amount (0.001%) is infinitesimal, and because the issuer will ultimately have to determine its arbitrage rebate liability based on the yield on the bond issue with no margin, bond counsel, in rendering their advice to issuers and documenting the transaction, typically just use the yield on the bond issue.

as “super-integration.” If an issue qualifies for super-integration, the issuer, in computing the yield on the issue, effectively takes into account only the rate it pays on the fixed leg of the swap; the variable interest rate on the issue and the rate paid on the variable leg of the swap are deemed under the Treasury Regulations to be equal to each other and thereby offset each other.¹⁰

One of the requirements for super-integration treatment is that, taking into account all payments made and received under the hedge and all payment on the hedged bonds, the issuer’s aggregate payments are fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. In the case of an interest rate swap, this requirement is most easily met when the variable rate on the bonds is equal to the variable rate on the swap, *i.e.*, a cost-of-funds swap. Section 1.148-4(h)(4)(C) further provides, however, that this requirement will also be met:

if payments on the bonds are based, in whole or in part, on one interest rate, payments on the hedge are based, in whole or in part, on a second interest rate that is substantially the same as, but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index may be substantially the same as an issuer’s individual 30-day interest rate.

Thus, the Treasury Regulations provide that, in certain situations, fixed yield treatment is available in the case of a variable yield issue hedged by an interest rate swap, even where the variable rate on the swap is based on an index.

As noted above, the variable rates on most interest rate swaps utilized in the municipal market are based on an index rather than on the issuer’s actual cost of funds. The issue that arises relates to the determination required under Section 1.148-4(h)(4)(C) of whether the index used as the basis for the variable leg of the swap can be considered to be “substantially the same” as the variable rate on the bonds. This issue is particularly difficult where the variable rate on the swap is based on an index derived from the taxable debt markets, such as LIBOR. While the Treasury Regulations specifically provide that a tax-exempt variable rate index may be considered substantially the same as an issuer’s individual rate, there is no express indication of whether a percentage of a taxable index such as LIBOR may also qualify. This question is very important to issuers because the lowest fixed rates available to issuers in hedging their variable rate obligations are typically found with LIBOR-based swaps for the reasons described above. As indicated in the Introduction, we hope that concrete guidance on this question will eventually be provided.

¹⁰ See Treas. Reg. § 1.148-4(h)(4)(ii), which provides in part: “If payments on the bonds and payments on the hedge are based, in whole or in part, on variable interest rates that are substantially the same within the meaning of paragraph (h)(4)(i)(C) of this section (but not identical), yield on the issue is determined by treating the variable interest rates as identical.” As with any other bond issue, the issuer may also take into account in computing yield any fees paid for credit enhancement (*e.g.*, bond insurance, liquidity support) where such credit enhancement constitutes a “qualified guarantee” under Section 1.148-4(f) of the Treasury Regulations.

C. Challenges for Issuers Under Basic Integration

The use of variable-to-fixed rate swaps has become commonplace in today's tax-exempt bond market. Issuers and their financial advisors increasingly find that undertaking an advance refunding of an existing issue of higher-yielding bonds using variable rate bonds together with a variable-to-fixed rate swap, instead of a traditional fixed rate bond issue, greatly enhances debt service savings. As a result of the absence of guidance regarding the tax treatment of LIBOR-based swaps, however, issuers are often unable to obtain an unqualified tax opinion from their bond counsel (or tax counsel) that super-integration applies in such transactions. As a result, these transactions employ "basic" integration pursuant to Section 1.148-4(h)(2) of the Treasury Regulations. As noted above, under the rules for basic integration, the advance refunding bond issue is treated as a variable yield issue under Section 1.148-4(c) of the Treasury Regulations, with the result that the yield on the bond issue will vary over its term, including the period of time in which the advance refunding escrow is in place (the "escrow period"). This variation results from the fact that, under basic integration, in computing the yield on the bonds the issuer must take into account the payments of debt service made on the bonds as well as all payments made or received by the issuer under the swap.¹¹ Accordingly, while payments under the fixed leg of the swap will remain constant, variations in yield will occur as a result of differences, reflecting basis risk, between the amount of interest the issuer pays on the bonds and the amount the issuer receives under the variable leg of the swap.¹²

D. Yield Compliance Techniques

Issuers and their counsel and financial advisors have devised various techniques to deal with the risk that the yield on the advance refunding bond issue will decrease during the escrow period such that the bond yield decreases to the point of being less than the yield on the escrow investments, even though the yield on the escrow investments started at a point below the bond yield. One of these techniques is the establishment of an "invested sinking fund" for the bond issue, into which the issuer covenants to make deposits of its own funds in such amounts and at such times, and invested at such rates, as is necessary to blend with the escrow investments and cause the yield on such combined investments to be below the bond yield. This is officially sanctioned by the Treasury Regulations.¹³ This technique, however, can be financially burdensome to an issuer in that it can result in the issuer being required to contribute a significant amount of funds to the transaction after issuance.

Another technique involves periodic restructuring of the advance refunding escrow. This technique, however, can be more cumbersome than the establishment of an invested sinking fund because, among other things, an issuer is generally required to obtain an

¹¹ In comparison, under super-integration, the issuer takes into account in calculating bond yield only the payments it makes under the fixed leg of the swap.

¹² To the extent payments on the variable leg of the swap exceed interest payments made on the bonds, the yield on the bonds will decrease. Conversely, to the extent interest payments on the bonds exceed payments on the variable leg of the swap, the yield on the bonds will increase.

¹³ See Treas. Reg. § 1.148-5(b)(2)(iii).

opinion of bond counsel each time the escrow investments are restructured, and generally is also required to obtain an independent CPA verification report supporting the cash-flow sufficiency of the escrow, which is critical when the prior issue of bonds has been legally defeased by the escrow. This technique may also involve bankruptcy concerns when the issuer contributes its own cash to the defeasance escrow.¹⁴

Issuers and their counsel have also employed the use of a negative arbitrage “cushion,” where the issuer builds into the escrow a certain amount of negative arbitrage in order to lessen the risk that “excess” swap payments cause the yield on the bonds to decline to the point of being less than the yield on the escrow investments. This, too, has its disadvantages, the most obvious of which is the increased cost to the issuer of effecting the advance refunding as a result of having to issue more bonds to fund a larger and more expensive escrow.

One or more of the above techniques is legally necessary because of the prohibition in Section 1.148-5(c)(3)(ii) of the Treasury Regulations against the use of yield reduction payments to reduce the yield on investments allocable to gross proceeds of an advance refunding issue other than certain “transferred proceeds” and certain “replacement proceeds,” neither of which provides relief to the above-described situation.¹⁵

While issuers and their counsel and financial advisors have developed these techniques to deal with the lack of express guidance regarding the ability to achieve fixed yield treatment for bonds hedged with LIBOR based swaps, the techniques add significant complexity and increase transaction costs. We believe that the proposed modification to the Treasury Regulations set forth below would be of significant benefit to issuers by avoiding these complexities and transaction costs, and at the same time would address IRS and Treasury concerns regarding any possible arbitrage benefits.

III. PROPOSED REGULATORY MODIFICATION

The proposal would modify Section 1.148-5(c) of the Treasury Regulations to permit yield reduction payments for advance refunding escrows that are funded in whole or in part from the proceeds of an issue of bonds where the issuer enters into a qualified hedge consisting of an interest rate swap that covers all of the variable rate bonds of the issue for the period beginning on the issue date of the issue and ending on or after the date of the final payment from the advance refunding escrow. To prevent issuers, however, from being able to invest the proceeds in the advance refunding escrow completely free of yield restriction (*i.e.*, based only on market limitations), the proposal requires the escrow to be invested in investments

¹⁴ Such money may not be “preference-protected” and would therefore be at risk if the issuer were to declare bankruptcy within a certain period after the money is deposited into the escrow. To deal with this concern, some counsel and financial advisors have developed agreements under which payments under the variable leg of the swap are captured and deposited directly into the escrow, to avoid such money passing through the issuer.

¹⁵ The ability to make yield reduction payments is provided for in Section 1.148-5(c) of the Treasury Regulations. Yield reduction payments enable an issuer to reduce the yield on its yield restricted investments so as to ensure that such investments do not violate the arbitrage rules. Section 1.148-5(c)(2) provides in part that yield reduction payments are to be “paid to the United States at the same time and in the same manner as rebate amounts are required to be paid or at such other time or in such manner as the Commissioner may prescribe.”

having a yield not greater than a fixed yield determined by taking into account the rate on the fixed leg of the swap.¹⁶ This proposed modification to the Treasury Regulations would enable issuers to utilize less costly LIBOR-based swaps in connection with their advance refundings without having to employ the above-described complex and, in many cases, costly techniques, and at the same time prevent issuers from obtaining any arbitrage benefit.

For example, suppose an issuer issues “weekly floaters” (bonds whose interest rate is reset every seven days) the net proceeds of which will be used to advance refund the issuer’s 1998 bonds. The 1998 bonds are callable at the option of the issuer beginning on June 1, 2008, and assume the issuer selects June 1, 2008, as the end of the first “computation period.”¹⁷ The issuer deposits the net proceeds of the advance refunding bonds in a yield restricted defeasance escrow, effecting a legal defeasance of the 1998 bonds. Concurrently with the issuance of the bonds, the issuer enters into a variable-to-fixed interest rate swap, pursuant to which, on a monthly basis, it will receive from the swap counterparty 65% of LIBOR and pay to the swap counterparty a fixed rate of 3.45%. For purposes of acquiring appropriate investments to deposit in the yield restricted defeasance escrow, the issuer would take into account in computing the yield on the advance refunding bonds the fixed rate of 3.45% it is obligated to pay on the swap. The interest rate on the bonds and the rate on the variable leg of the swap (a function of 65% of LIBOR) are treated as offsetting each other.¹⁸

Suppose, based on this methodology, that the yield on the advance refunding bonds for the first computation period is 3.65%, and that the investments purchased with the proceeds deposited in the yield restricted defeasance escrow produce a yield of 3.65%. If, because amounts received under the variable leg of the swap exceed amounts paid as interest on the advance refunding bonds, the yield on the advance refunding bonds for the first computation period is 3.30%, the issuer will be required to make a yield reduction payment reflecting the excess of the 3.65% it earned on the escrow investments over the actual bond yield of 3.30%.¹⁹

¹⁶ As with super-integration, payments under the variable leg of the swap are treated as equal to payments of interest on the bonds, so that they offset each other, leaving the fixed payments on the swap. Credit enhancement fees, of course, can still be taken into account to the extent the credit enhancement constitutes a qualified guarantee. This “limited” form of super-integration, however, is solely for purposes of determining the maximum yield at which the escrow may be invested. Ultimately, the issuer will be required to pay a yield reduction payment to the extent it has positive arbitrage. This differs from true super-integration, where a yield reduction payment would not be required.

¹⁷ The term “computation period” is defined in Section 1.148-1 of the Treasury Regulations as the period between “computation dates.” The first computation period begins on the issue date of the bond issue and ends on the first computation date. An issuer has a fair degree of latitude in the selection of the first computation date, so long as such date is within five years of the issue date. A detailed discussion of computation periods and computation dates is beyond the scope of this submission.

¹⁸ The issuer may also take into account in computing bond yield any fees it pays for credit enhancement on the bonds that constitutes a qualified guarantee under Section 1.148-4(f) of the Treasury Regulations.

¹⁹ Conversely, if, because amounts received under the variable leg of the swap are less than amounts paid as interest on the advance refunding bonds, the yield on the advance refunding bonds for the first

The text of the proposed modification to the Treasury Regulations is set forth in the Appendix to this report.

IV. ALTERNATIVE AMENDMENT TO SECTION 1.148-5(c) OF THE TREASURY REGULATIONS

We submit that the Treasury Department may, alternatively, wish to consider eliminating entirely the prohibition against the use of yield reduction payments with respect to the proceeds of an advance refunding bond issue or eliminating entirely all of the complex limitations on the use of yield reduction payments. While the recommendation made herein is narrowly focused and thus does not purport to address the perhaps broader policy involved with such elimination, including allowing issuers to effect unhedged (or partially hedged) variable rate advance refundings,²⁰ we think that there may well be sound reasons for the Treasury Department to reconsider its original position in including the advance refunding prohibition in Section 1.148-5(c) of the Treasury Regulations. The complex restrictions on the use of yield reduction payments contained in Section 1.148-5(c) of the Treasury Regulations appear to serve no articulated policy under Section 148 of the Code. If this approach is adopted, it could be implemented by simply deleting Section 1.148-5(c)(3)(ii) of the Treasury Regulations.

computation period is 3.80%, the issuer will be not be required to make a yield reduction payment. Ways in which the issuer might “capture” such “negative arbitrage” are beyond the scope of this submission.

²⁰An issuer then would be able to issue variable rate bonds and later make a yield reduction payment reflecting the positive arbitrage based on the difference between its lower variable rate (*e.g.*, seven-day paper) and higher-yielding fixed rate advance refunding escrow.

APPENDIX

Par __. In paragraph (c)(3)(ii)(B) of Section 1.148-5, the word “and” at end of such paragraph is stricken.

Par __. In paragraph (c)(3)(ii)(C) of Section 1.148-5, the period at the end of such paragraph is stricken and replaced by: “; and”

Par __. The following new paragraph (c)(3)(ii)(D) of Section 1.148-5 is added:

(D) Proceeds of an advance refunding issue deposited in a yield restricted defeasance escrow if—

(1) the issuer has entered into a qualified hedge within the meaning of § 1.148-4(h)(2) consisting of an interest rate swap that covers all of the variable rate bonds of the issue for a period beginning on the issue date of the issue and ending on or after the date on which the final payment is expected to be made from the yield restricted defeasance escrow; and

(2) during a computation period equal to the term of the interest rate swap, the yield on the proceeds of the issue in the yield restricted defeasance escrow (determined without regard to this paragraph (c)(1)(D)) is less than the yield on the issue, with the yield on the issue for this purpose determined by taking into account all of the issuer’s payments made on the interest rate swap and treating the interest payments on the issue as equal to the payments received by the issuer under the interest rate swap.