[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8801]

RIN 1545-AU39

Arbitrage Restrictions on Tax-Exempt Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the arbitrage restrictions applicable to tax-exempt bonds issued by State and local governments. Changes to applicable law were made by the Tax Reform Act of 1986. These regulations affect issuers of tax-exempt bonds and provide guidance for complying with the arbitrage regulations.

DATES: Effective Date: These regulations are effective on March 1, 1999.

Applicability Date: These regulations are applicable to bonds sold on or after March 1, 1999. Issuers may apply these regulations to bonds sold on or after December 30, 1998. and before March 1, 1999.

FOR FURTHER INFORMATION CONTACT: David White, 202-622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of

Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1490. Responses to these collections of information are required to obtain the benefits of a safe harbor.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per record keeper varies from .75 hour to 2 hours, depending on individual circumstances, with an estimated average of 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

These final regulations contain amendments to the income tax regulations (26 CFR Part 1) under section 148 of the Internal Revenue Code of 1986 (Code). Section 148 provides rules

addressing the use of proceeds of tax-exempt State and local bonds to acquire higher-yielding investments. On June 18, 1993, final regulations (TD 8476) relating to the arbitrage restrictions and related rules under sections 103, 148, 149, and 150 were published in the **Federal Register** (58 FR 33510). Corrections to these regulations were published in the **Federal Register** on August 23, 1993 (58 FR 44451), and May 11, 1994 (59 FR 24350).

On June 27, 1996, a notice of proposed rulemaking (FI-28-96) relating to the arbitrage restrictions was published in the **Federal Register** (61 FR 33405). The proposed regulations provide a rebuttable presumption for establishing fair market value for United States Treasury obligations that are purchased other than directly from the United States Treasury. In addition, the proposed regulations provide a rebuttable presumption that a solicitation that meets certain requirements is a bona fide solicitation for the guaranteed investment contract safe harbor of §1.148-5(d)(6)(iii). A public hearing was held on Thursday, October 24, 1996, and written comments were received. After consideration of all the comments, the regulations proposed by FI-28-96 are, with modifications, adopted by revision to §1.148-5(d)(6)(iii). The changes are discussed below.

Explanation of Provisions

A. <u>In General</u>

Due to concerns regarding the fair market purchase price of United States Treasury obligations purchased other than directly

from the United States Treasury, the proposed regulations provide a rebuttable presumption for establishing fair market value. The proposed regulations generally apply the principles underlying the existing safe harbor in the arbitrage regulations for establishing fair market value for guaranteed investment contracts.

The proposed regulations also provide a rebuttable presumption that a solicitation meeting the requirements of the proposed regulations will be a bona fide solicitation for the guaranteed investment contract safe harbor of existing §1.148-5(d)(6)(iii).

Modifications to the proposed regulations have been made to clarify various technical aspects in response to comments received.

B. Safe Harbor

Commentators noted that a rebuttable presumption in the proposed regulations for purchases of United States Treasury obligations provides a lower level of protection to issuers than the safe harbor applicable to guaranteed investment contracts. Commentators generally requested that the final regulations provide a safe harbor for the purchase of United States Treasury obligations.

The final regulations create a safe harbor for all investments covered by the regulations, provided that the issuer receives at least three bids as required by the regulations. The premise of the final regulations is that a bidding procedure

satisfying the requirements of the final regulations will produce a price that equals fair market value. If the requirements of the final regulations are not in fact met, no assumption can be made about the relationship of the price paid to fair market value. However, all reasonable and prudent actions taken by the issuer under the circumstances may be considered in determining whether the issuer paid fair market value.

C. Scope of Final Regulations

Generally, the proposed regulations apply to United States Treasury obligations purchased other than directly from the United States Treasury. Commentators requested clarification regarding the scope of the proposed regulations and requested that the regulations only apply to investments purchased for yield restricted refunding and yield restricted sinking fund escrows. In addition, commentators asked that the proposed regulations be expanded to apply to other types of investments that may be purchased for an escrow (e.g., REFCORP strips).

The final regulations apply only to guaranteed investment contracts and yield restricted defeasance escrows. With respect to yield restricted defeasance escrows, the final regulations expand the scope of investments covered by the proposed regulations to apply to all investments purchased for the escrow (e.g., United States Agency obligations, REFCORP strips and corporate obligations).

D. Guaranteed Investment Contracts

Commentators requested clarification regarding which

investments are covered by the safe harbor for guaranteed investment contracts and which would be covered by the proposed regulations.

The term guaranteed investment contract generally does not include investments purchased for a yield restricted defeasance escrow. However, the term guaranteed investment contract does include escrow float contracts and similar agreements purchased for a yield restricted defeasance escrow. In addition, the term guaranteed investment contract includes debt service fund forward agreements and debt service reserve fund agreements (e.g., agreements to deliver United States Treasury obligations over a period of time).

E. No Last Look

The proposed regulations state that all providers must have equal opportunity to bid and that no provider is permitted to review other bids before bidding (e.g., a last look). A small number of commentators noted that the existence of a last look may result in higher yields from competing providers. The final regulations retain the no last look requirement because permitting a last look may adversely affect the bona fides of the bidding process.

F. Reasonably Competitive Providers

The proposed regulations provide that all bidders are required to be reasonably competitive providers of investments of the type being purchased. Numerous comments were received regarding the meaning of the phrase “reasonably competitive

provider," and commentators expressed concern that a bid from a non-competitive provider may prevent the requirements of the regulations from being satisfied.

The final regulations modify this provision. The final regulations provide that the issuer must solicit at least three bids from reasonably competitive providers and that the issuer must receive at least one bid from a reasonably competitive provider. For purposes of the final regulations, a reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased. For example, in connection with the solicitation of bids for a guaranteed investment contract, an entity that has an established industry reputation as a competitive provider of guaranteed investment contracts is a reasonably competitive provider.

G. No Material Financial Interest

The proposed regulations, like the existing safe harbor for guaranteed investment contracts, provide that the issuer must receive at least three bona fide bids from providers that have no material financial interest in the issue. For this purpose, the proposed regulations provide that underwriters and financial advisors for an issue are considered to have a material financial interest. Numerous comments were received regarding the scope of entities that are considered to have a material financial interest under the proposed regulations.

The final regulations clarify that, for purchases of any

investment covered by the safe harbor, the 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. Any entity acting as a financial advisor with respect to the purchase of the investment at the time that the bid specification form is submitted to potential providers is also deemed to have a material financial interest in the issue. In addition, the final regulations require the provider to represent that its bid is not based on any other formal or informal agreement that the provider has with the issuer or any other person. A provider that is a related party to a provider that has a material financial interest in the issue is also deemed to have a material financial interest in the issue.

H. Commercially Reasonable Terms

The proposed regulations provide that the terms of the purchase agreement must be reasonable. The existing safe harbor for guaranteed investment contracts provides that the terms of the guaranteed investment contract, including the collateral security requirements, must be reasonable. A number of commentators requested clarification regarding what reasonable means in connection with a solicitation of United States Treasury obligations.

The final regulations provide that the terms of the bid specification for any investment covered by the safe harbor must be commercially reasonable. A term is commercially reasonable if there is a legitimate business purpose for including the term in

the bid specifications other than to lower the yield or increase the cost of the bid. For example, in connection with the solicitation of investments for a yield restricted defeasance escrow, a commercially unreasonable term would be a hold firm period that is longer than the issuer reasonably requires.

I. Comparison to State and Local Government Series Securities

The proposed regulations provide that the yield on any United States Treasury obligation purchased by the issuer may not be less than the yield then available on State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt (SLGs) with the same maturity. Commentators requested that the SLGs comparison be removed or that issuers be allowed to make the comparison on a portfolio-by-portfolio basis. Commentators also requested guidance about the time period in which the SLGs comparison is to be made.

In general, the final regulations provide that the safe harbor does not apply to investments purchased for a yield restricted defeasance escrow if the lowest cost bid is greater than the cost of the most efficient SLG portfolio. The final regulations provide that the lowest cost bid is the lowest bid for the portfolio or, if the issuer compares bids on an investment-by-investment basis, the aggregate cost of a portfolio comprised of the lowest cost bid for each investment. Any payment received by the issuer from a provider at the time a guaranteed investment contract is purchased (e.g., an escrow

float contract) for a yield restricted defeasance escrow under a bidding procedure meeting the requirements of the final regulations is taken into account in determining the lowest cost bid.

The final regulations provide the following rules for comparing the lowest cost bid to SLGs. First, the most efficient SLG portfolio consists of one or more SLG securities that will allow the issuer to defease the refunded obligations at the lowest overall cost. Second, the comparison of the most efficient SLG portfolio and the lowest cost bid must be made at the time that bids are required to be submitted pursuant to the terms of the bid specifications. Intra-day pricing movements and closing spot prices of investments before and after the time in which the comparison to SLGs is required to be made are not relevant. Third, if SLGs are not available for purchase on the day that bids are required to be submitted pursuant to terms of the bid specifications because Treasury has suspended sales of those securities, the comparison of the most efficient SLG portfolio to the lowest cost bid is not required.

No comparison to SLGs is required for purchases of guaranteed investment contracts.

J. Forward Pricing Data

The proposed regulations provide that the yield on United States Treasury obligations purchased by the issuer may not be significantly less than the yield then available from the provider on reasonably comparable United States 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. If closely comparable forward prices are not available, a reasonable basis for this comparison may be by reference to implied forward prices for Treasury obligations based on standard financial formulas. A certificate provided by the agent conducting the bidding process will establish that the comparison is met. The existing safe harbor for guaranteed investment contracts provides that the yield on the guaranteed investment contract may not be less than the yield then available from the provider on reasonably comparable guaranteed investment contracts, if any, offered to other persons from a source of funds other than gross proceeds of tax-exempt bonds.

Commentators noted that, in general, the comparison required by the proposed regulations is either too complex or not possible to construct. In lieu of a comparability requirement, commentators recommended that the regulations adopt certain additional safeguards to protect the integrity of the bidding process.

The final regulations remove the comparability requirement for all investments covered by the safe harbor. However, the final regulations include additional requirements to ensure a competitive bidding process. For example, the final regulations require that the bid form forwarded to potential providers include a statement notifying providers that by submitting a bid

the potential provider is representing that it did not consult with any other providers about their bid, and that its bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the requirement that the issuer receive three bids. It is anticipated that these additional requirements will ensure that the bids reflect fair market value, as determined without regard to the source of funds.

K. Record Keeping Requirements

The proposed regulations provide that issuers are required to retain certain records and information with the bond documents, including a copy of the bids received (date and time stamped). Numerous comments were received regarding the difficulty of obtaining written bids for Treasury obligations.

The final regulations modify the record keeping requirements and apply those requirements to guaranteed investment contracts. One modification to the record keeping requirements is the elimination of the requirement that the bids be received in writing. The final regulations provide that the requirement for recording the bid is satisfied if the issuer or its agent makes a contemporaneous record of the bid, including the time and date each bid was received, and the identification of the person and entity submitting the bid, and keeps this record with the bond documents.

The final regulations also provide that, if the terms of the purchase agreement deviate from the terms of the bid solicitation form or if a submitted bid is modified, the issuer must keep a

record explaining the purpose of the deviation or modification and, if the purchase agreement price differed from the bid, how that price was determined. If the issuer replaces investments in the winning bid portfolio with other investments, the prices of the new investments are not protected by the safe harbor unless those investments are bid under a bidding procedure meeting the requirements of the final regulations.

L. Broker Fees for Yield Restricted Defeasance Escrows

The proposed regulations provide that a fee paid to a bidding agent is a qualified administrative cost only if the fee is comparable to a fee that would be charged for a reasonably comparable investment of obligations acquired with a source of funds other than gross proceeds of tax-exempt bonds and the fee is reasonable. Under the proposed regulations, the fee is presumed to be reasonable if it does not exceed .02 percent of the amount invested in United States Treasury obligations. Commentators noted that the comparability requirement was unclear and that outside the context of municipal bonds, bidding for closely comparable investments is virtually non-existent. Commentators also noted that the .02 percent fee may result in too much compensation in the case of large escrows and too little compensation in the case of small escrows.

The final regulations retain the comparability and reasonableness requirements. However, the final regulations provide that a broker’s fee will meet the reasonableness and comparability requirements if the fee does not exceed the lesser

of $10,000 or .1 percent of the initial principal amount of investments purchased for the yield restricted defeasance escrow.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the amount of time required to meet the record keeping requirement of these final regulations, an estimated annual average of 1 hour per taxpayer, is small. Also, the regulations affect a small number of taxpayers, approximately 1400 annually. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are David White and Rebecca Harrigal of the IRS Office of Chief Counsel and Edwin G. Oswald of the Department of the Treasury. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.148-5 is amended as follows:

1. Paragraph (d)(6)(iii) is revised.

2. Paragraph (e)(2)(iv) is added.

The revision and addition read as follows:

§1.148-5 Yield and valuation of investments.

* * * * *

(d) * * *

(6) * * *

(iii) Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow. The purchase price of a guaranteed investment contract and the purchase price of an investment purchased for a yield restricted defeasance escrow will be treated as the fair market value of the investment on the purchase date if all of the following requirements are satisfied:

(A) The issuer makes a bona fide solicitation for the

purchase of the investment. A bona fide solicitation is a solicitation that satisfies all of the following requirements:

(1) The bid specifications are in writing and are timely forwarded to potential providers.

(2) The bid specifications include all material terms of the bid. A term is material if it may directly or indirectly affect the yield or the cost of the investment.

(3) The bid specifications include a statement notifying potential providers that submission of a bid is a representation that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any other formal or informal agreement that the potential provider has with the issuer or any other person (whether or not in connection with the bond issue), and that the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the requirements of paragraph (d)(6)(iii)(B)(1) or (2) of this section.

(4) The terms of the bid specifications are commercially reasonable. A term is commercially reasonable if there is a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of the investment. For example, for solicitations of investments for a yield restricted defeasance escrow, the hold firm period must be no longer than the issuer reasonably requires.

(5) For purchases of guaranteed investment contracts only, the terms of the solicitation take into account the issuer’s

reasonably expected deposit and drawdown schedule for the amounts to be invested.

(6) All potential providers have an equal opportunity to bid. For example, no potential provider is given the opportunity to review other bids (i.e., a last look) before providing a bid.

(7) At least three reasonably competitive providers are solicited for bids. A reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

(B) The bids received by the issuer meet all of the following requirements:

(1) The issuer receives at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of paragraph (d)(6)(iii)(A) of this section and that do not have a material financial interest in the issue. 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. In addition, any entity acting as a financial advisor with respect to the purchase of the investment at the time the bid specifications are forwarded to potential providers has a material financial interest in the issue. A provider that is a related party to a provider that has a material financial interest in the issue is deemed to have a material financial interest in the issue.

(2) At least one of the three bids described in paragraph (d)(6)(iii)(B)(1) of this section is from a reasonably

competitive provider, within the meaning of paragraph (d)(6)(iii)(A)(7) of this section.

(3) If the issuer uses an agent to conduct the bidding process, the agent did not bid to provide the investment.

(C) The winning bid meets the following requirements:

(1) Guaranteed investment contracts. If the investment is a guaranteed investment contract, the winning bid is the highest yielding bona fide bid (determined net of any broker's fees).

(2) Other investments. If the investment is not a guaranteed investment contract, the following requirements are met:

(i) The winning bid is the lowest cost bona fide bid (including any broker's fees). The lowest cost bid is either the lowest cost bid for the portfolio or, if the issuer compares the bids on an investment-by-investment basis, the aggregate cost of a portfolio comprised of the lowest cost bid for each investment. Any payment received by the issuer from a provider at the time a guaranteed investment contract is purchased (e.g., an escrow float contract) for a yield restricted defeasance escrow under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii) is taken into account in determining the lowest cost bid.

(ii) The lowest cost bona fide bid (including any broker's fees) is not greater than the cost of the most efficient portfolio comprised exclusively of State and Local Government Series Securities from the United States Department of the

Treasury, Bureau of Public Debt. The cost of the most efficient portfolio of State and Local Government Series Securities is to be determined at the time that bids are required to be submitted pursuant to the terms of the bid specifications.

(iii) If State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt are not available for purchase on the day that bids are required to be submitted pursuant to terms of the bid specifications because sales of those securities have been suspended, the cost comparison of paragraph (d)(6)(iii)(C)(2)(ii) of this section is not required.

(D) The provider of the investments or the obligor on the guaranteed investment contract certifies the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment.

(E) The issuer retains the following records with the bond documents until three years after the last outstanding bond is redeemed:

(1) For purchases of guaranteed investment contracts, a copy of the contract, and for purchases of investments other than guaranteed investment contracts, the purchase agreement or confirmation.

(2) The receipt or other record of the amount actually paid by the issuer for the investments, including a record of any administrative costs paid by the issuer, and the certification under paragraph (d)(6)(iii)(D) of this section.

(3) For each bid that is submitted, the name of the person and entity submitting the bid, the time and date of the bid, and the bid results.

(4) The bid solicitation form and, if the terms of the purchase agreement or the guaranteed investment contract deviated from the bid solicitation form or a submitted bid is modified, a brief statement explaining the deviation and stating the purpose for the deviation. For example, if the issuer purchases a portfolio of investments for a yield restricted defeasance escrow and, in order to satisfy the yield restriction requirements of section 148, an investment in the winning bid is replaced with an investment with a lower yield, the issuer must retain a record of the substitution and how the price of the substitute investment was determined. If the issuer replaces an investment in the winning bid portfolio with another investment, the purchase price of the new investment is not covered by the safe harbor unless the investment is bid under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii).

(5) For purchases of investments other than guaranteed investment contracts, the cost of the most efficient portfolio of State and Local Government Series Securities, determined at the time that the bids were required to be submitted pursuant to the terms of the bid specifications.

(e) * * *

(2) * * *

(iv) Special rule for investments purchased for a yield

restricted defeasance escrow. For investments purchased for a yield restricted defeasance escrow, a fee paid to a bidding agent is a qualified administrative cost only if the following requirements are satisfied:

(A) The fee is comparable to a fee that would be charged for a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds, and it is reasonable. The fee is deemed to be comparable to a fee that would be charged for a comparable investment acquired with a source of funds other than gross proceeds of tax-exempt bonds, and to be reasonable if the fee does not exceed the lesser of $10,000 or .1% of the initial principal amount of investments deposited in the yield restricted defeasance escrow.

(B) For transactions in which a guaranteed investment contract and other investments are purchased for a yield restricted defeasance escrow in a single investment (e.g., an issuer bids United States Treasury obligations and an escrow float contract collectively), a broker's fee described in paragraph (e)(2)(iv)(A) of this section will apply to the initial principal amount of the investment deposited in the yield restricted defeasance escrow, and a broker's fee described in paragraph (e)(2)(iii) of this section will apply only to the guaranteed investment contract portion of the investment.

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PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (c) is amended by revising the entry for 1.148-5 in the table to read as follows:

§602.101 OMB Control numbers.

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(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.148-5	1545-1098 1545-1490
* * * * *	

/s/ Robert E. Wenzel

Deputy Commissioner of Internal Revenue

Approved: December 17, 1998

/s/ Donald C. Lubick
Assistant Secretary of the Treasury