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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9097

RIN 1545-AX22

Arbitrage restrictions applicable to tax-exempt bonds issued by state and local governments

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. The regulations affect issuers of tax-exempt bonds and provide a safe harbor for qualified administrative costs for broker's commissions and similar fees incurred in connection with the acquisition of guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow.

DATES: Effective Date: These regulations are effective February 9, 2004.

Applicability Date: For dates of applicability, see §1.148-11(i) of these regulations.

FOR FURTHER INFORMATION CONTACT: Rose M. Weber, (202) 622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 under section 148 of the Internal Revenue Code by providing rules for determining when certain brokers' commissions or similar fees are qualified administrative costs (the final regulations). On August 27, 1999, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-105565-99)(64 FR 46876) (the proposed regulations). The proposed regulations modify §1.148-5(e)(2) to provide a safe harbor for determining whether brokers' commissions and similar fees incurred in connection with the acquisition of guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow are treated as qualified administrative costs. Comments on the proposed regulations were received and a hearing was held on December 14, 1999. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

I. Existing Regulations

A. Investment yield and administrative costs

Section 148 limits the yield on investments purchased

with proceeds of tax-exempt bonds. In general, under §1.148-5(b)(1) of the existing regulations, the yield on an investment is computed by comparing receipts from the investment to payments for the investment. Section 1.148-5(e)(1) provides that the yield on an investment generally is not adjusted to take into account any costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment (administrative costs). However, §1.148-5(e)(2)(i) provides that the yield on nonpurpose investments (as defined in §1.148-1(b)) is adjusted to take into account qualified administrative costs. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. In general, under §1.148-5(e)(2)(i), administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds (the comparability standard).

B. Special rule for guaranteed investment contracts

Section 1.148-5(e)(2)(iii) of the existing regulations provides that, for a guaranteed investment contract, a

broker's commission or similar fee paid on behalf of either an issuer or the guaranteed investment contract provider generally is a qualified administrative cost to the extent that the present value of the commission, as of the date the contract is allocated to the issue, does not exceed the lesser of (x) a reasonable amount within the meaning of §1.148-5(e)(2)(i) or (y) the present value of annual payments equal to .05 percent of the weighted average amount reasonably expected to be invested each year of the term of the contract. Present value is computed using the taxable discount rate used by the parties to compute the commission, or if not readily ascertainable, the yield to the issuer on the investment contract or other reasonable taxable discount rate.

C. Special rule for yield restricted defeasance escrows

Section 1.148-5(e)(2)(iv) of the existing regulations provides that, for investments purchased for a yield restricted defeasance escrow, 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 if acquired with a source of funds other than gross proceeds of tax-exempt bonds, and it is reasonable. The fee is deemed to meet both the comparability and reasonableness requirements if it does not exceed the lesser of $10,000 or .1

percent of the initial principal amount of investments deposited in the yield restricted defeasance escrow.

II. Proposed Regulations

The proposed regulations were issued in response to comments stating that issuers were having difficulty applying §1.148-5(e)(2)(iii) and (iv), primarily because of uncertainty about whether a particular broker's commission or similar fee is reasonable. The proposed regulations delete the existing provisions of §1.148-5(e)(2)(iii) and (iv) and create a single rule for qualified administrative costs that treats a broker's commission or similar fee incurred in connection with a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow as a qualified administrative cost if the fee is reasonable within the meaning of §1.148-5(e)(2)(i) of the existing regulations.

The proposed regulations also set forth a safe harbor, which treats a broker's commission or similar fee incurred in connection with the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow as reasonable within the meaning of §1.148-5(e)(2)(i) if two requirements are met. Under the first requirement for the safe harbor, the amount of the broker's commission or similar fee treated by the issuer as a qualified

administrative cost cannot exceed the lesser of $25,000 or 0.2 percent of the computational base (the per-investment safe harbor). For guaranteed investment contracts, the computational base is the aggregate amount reasonably expected as of the issue date to be deposited over the term of the contract. For example, for a guaranteed investment contract used to earn a return on what otherwise would be idle cash balances from maturing investments in a yield restricted defeasance escrow, the aggregate amount reasonably expected to be deposited includes all periodic deposits reasonably expected to be made pursuant to the terms of the contract. For investments, other than guaranteed investment contracts, deposited in a yield restricted defeasance escrow, the computational base is the initial amount invested in those investments. Under the second requirement for the safe harbor, for any issue of bonds, the issuer cannot treat as qualified administrative costs more than $75,000 in brokers' commissions or similar fees with respect to all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue (the per-issue safe harbor).

III. Final Regulations

A. Safe harbor approach

Some commentators suggested that the existing regulations, coupled with competitive market forces, work well to produce reasonable brokers' fees. Commentators also suggested that the proposed regulations will eliminate much of the incentive for the independent bidding agent to actively participate in the market, with the result that, in many cases, tax-exempt bond proceeds will be placed in lower-yielding and often riskier investments. These commentators recommended against adopting the safe harbor in the proposed regulations.

Other commentators suggested that the existing regulations do not work well. They stated that the current rules provide little practical guidance upon which an issuer can rely to determine whether a broker's fee for a guaranteed investment contract is a reasonable amount. These commentators recommended that the safe harbor be adopted with modifications. They suggested that the safe harbor will provide a much needed level of certainty.

The IRS and Treasury Department do not believe the final regulations will result in tax-exempt bond proceeds being invested in low-yielding, risky investments because the regulations do not adversely affect an issuer's incentive to realize investment earnings and to invest in secure

investments. To provide simplicity and certainty, the final regulations retain the safe harbor, with certain modifications discussed below. The final regulations do not limit the amount of brokers' fees that may be paid by issuers. Thus, for example, the final regulations do not restrict the ability of an issuer to pay a particular fee that exceeds the safe harbor amount. Furthermore, brokers' commissions or similar fees in excess of the safe harbor are qualified administrative costs if they are reasonable within the meaning of §1.148-5(e)(2)(i).

B. Per-investment safe harbor

Commentators suggested that, if the per-investment safe harbor is retained, it should be increased. These commentators stated that in some circumstances the safe harbor does not reflect the value provided by brokers, particularly in the case of small or large transactions and long-term debt service reserve fund investments. Suggestions for modifying the per-investment safe harbor included adding a minimum fee for smaller transactions and a sliding scale for larger transactions. Commentators also suggested increasing the computational base for long-term guaranteed investment contracts by treating them as a series of shorter-term contracts.

The final regulations increase the $25,000 amount to $30,000 and provide for a minimum fee of $3,000. Thus, if 0.2 percent of the computational base is less than $3,000, the per-investment safe harbor is $3,000. The final regulations do not adopt a sliding scale and do not treat long-term contracts as a series of shorter-term contracts because the IRS and Treasury Department have concluded that the per-investment safe harbor in the final regulations provides much needed certainty without requiring issuers to pay less than fair market value for brokers' fees.

C. Per-issue safe harbor

Commentators recommended that the per-issue safe harbor be increased or eliminated. Some commentators suggested replacing the per-issue safe harbor with an anti-abuse rule to prevent the artificial creation of multiple investments when a single investment would be appropriate. Suggestions included aggregating separate investments that (1) are made at or about the same time if the bond proceeds being invested have similar rebate or yield characteristics, or (2) would normally be bid together as a single investment unless there was a good business reason for the separation.

The final regulations retain the per-issue safe harbor and increase the $75,000 amount to $85,000. To maintain

simplicity and certainty, the final regulations do not adopt the suggestion to replace the per-issue safe harbor with an anti-abuse rule. The IRS and Treasury Department have concluded that the per-issue safe harbor in the final regulations limits artificial separation of investments without requiring issuers to pay less than fair market value for brokers' fees.

D. Fees in excess of safe harbor

Some commentators requested guidance on the factors for determining whether a fee in excess of the safe harbor is reasonable. Suggested factors included the duration of the contract, the complexity of its terms, the creditworthiness of the issuer, the availability of providers to deliver the contract, the presence of unusual features in the issue or the contract, custom in the industry, and the level of risk to the broker. The IRS and Treasury Department have considered the suggested factors and have concluded that they do not represent administrable standards for determining whether a particular fee is reasonable. Therefore, the final regulations do not specify factors for determining the reasonableness of fees in excess of the safe harbor. Under the final regulations, the determination of whether a fee is reasonable is made based on all the facts and circumstances,

including whether the fee satisfies the comparability standard in §1.148-5(e)(2)(i).

Some commentators suggested that the portion of a fee that is within the safe harbor should be a qualified administrative cost, even if the total fee exceeds the safe harbor. The final regulations adopt this suggestion.

E. Computational base for guaranteed investment contracts

Commentators suggested that the computational base for a guaranteed investment contract should be determined as of the date the contract is acquired, rather than the issue date, so that the safe harbor may be applied to guaranteed investment contracts that are not anticipated on the issue date. The final regulations adopt this suggestion.

F. Cost-of-living adjustments

Commentators requested that the final regulations provide for periodic adjustments to the dollar limits in the safe harbor to reflect inflation. The final regulations provide a cost-of-living adjustment for both the per-investment safe harbor and the per-issue safe harbor. The adjusted safe harbor dollar amounts will be published in the annual revenue procedure that sets forth inflation-adjusted items.

G. Interpretative rule

One commentator questioned whether the proposed

regulations should have been classified as a legislative rule. The IRS and Treasury Department have reviewed the applicable authorities and have determined that the regulations are properly classified as an interpretative rule.

Effective Dates

The final regulations apply to bonds sold on or after February 9, 2004. In the case of bonds sold before February 9, 2004 that are subject to §1.148-5 (pre-effective date bonds), issuers may apply the final regulations, in whole but not in part, with respect to transactions entered into on or after December 11, 2003. If an issuer applies the final regulations to pre-effective date bonds, the per-issue safe harbor is applied by taking into account all brokers' commissions or similar fees with respect to guaranteed investment contracts and investments for yield restricted defeasance escrows that the issuer treats as qualified administrative costs for the issue, including all such commissions or fees paid before February 9, 2004. For purposes of §§1.148-5(e)(2)(iii)(B)(3) and 1.148-5(e)(2)(iii)(B)(6) of the final regulations (relating to cost-of-living adjustments), transactions entered into before 2003 are treated as entered into in 2003.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply.

Drafting Information

The principal authors of these final regulations are Rose M. Weber and Rebecca L. Harrigal, Office of Chief Counsel, IRS (TE/GE), and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 1.148-0 is amended by revising the entry in paragraph (c) for §1.148-11 (i) to read as follows:

§1.148-0 Scope and table of contents.

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(c) Table of contents.

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§1.148-11 Effective dates.

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(i) Special rule for certain broker’s commissions and similar fees.

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Par. 3. In §1.148-5, paragraph (e) is amended follows:

1. Paragraph (e)(2)(iii) is revised.

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

The revision reads as follows:

§1.148-5 Yield and valuation of investments.

* * * * *

(e) * * *

(2) * * *

(iii) Special rule for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow--(A) In general. An amount paid for a broker's commission or similar fee with respect to a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is a qualified administrative cost if the fee is reasonable within the meaning of paragraph

(e)(2)(i) of this section.

(B) Safe harbor--(1) In general. A broker's commission or similar fee with respect to the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is reasonable within the meaning of paragraph (e)(2)(i) of this section to the extent that--

(i) The amount of the fee that the issuer treats as a qualified administrative cost does not exceed the lesser of:

(A) $30,000; and

(B) 0.2% of the computational base or, if more, $3,000; and

(ii) For any issue, the issuer does not treat as qualified administrative costs more than $85,000 in brokers' commissions or similar fees with respect to all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue.

(2) Computational base. For purposes of paragraph (e)(2)(iii)(B)(1) of this section, computational base shall mean--

(i) For a guaranteed investment contract, the amount of gross proceeds the issuer reasonably expects, as of the date the contract is acquired, to be deposited in the guaranteed investment contract over the term of the contract, and

(ii) For investments (other than guaranteed investment contracts) to be deposited in a yield restricted defeasance escrow, the amount of gross proceeds initially invested in those investments.

(3) Cost-of-living adjustment. In the case of a calendar year after 2004, each of the dollar amounts in paragraph (e)(2)(iii)(B)(1) of this section shall be increased by an amount equal to--

(i) Such dollar amount; multiplied by

(ii) The cost-of-living adjustment determined under section 1(f)(3) for such calendar year by using the language "calendar year 2003" instead of "calendar year 1992" in section 1(f)(3)(B).

(4) Rounding. If any increase determined under paragraph (e)(2)(iii)(B)(3) of this section is not a multiple of $1,000, such increase shall be rounded to the nearest multiple thereof.

(5) Applicable year for cost-of-living adjustment. The cost-of-living adjustments under paragraph (e)(2)(iii)(B)(3) of this section shall apply to the safe harbor amounts under paragraph (e)(2)(iii)(B)(1) of this section based on the year the guaranteed investment contract or the investments for the yield restricted defeasance escrow, as applicable, are

acquired.

(6) Cost-of-living adjustment to determine remaining amount of per-issue safe harbor--(i) In general. This paragraph (e)(2)(iii)(B)(6) applies to determine the portion of the safe harbor amount under paragraph (e)(2)(iii)(B)(1)(ii) of this section, as modified by paragraph (e)(2)(iii)(B)(3) of this section (the per-issue safe harbor), that is available (the remaining amount) for any year (the determination year) if the per-issue safe harbor was partially used in one or more prior years.

(ii) Remaining amount of per-issue safe harbor. The remaining amount of the per-issue safe harbor for any determination year is equal to the per-issue safe harbor for that year, reduced by the portion of the per-issue safe harbor used in one or more prior years.

(iii) Portion of per-issue safe harbor used in prior years. The portion of the per-issue safe harbor used in any prior year (the prior year) is equal to the total amount of broker’s commissions or similar fees paid in connection with guaranteed investment contracts or investments for a yield restricted defeasance escrow acquired in the prior year that the issuer treated as qualified administrative costs for the issue, multiplied by a fraction the numerator of which is the

per-issue safe harbor for the determination year and the denominator of which is the per-issue safe harbor for the prior year. See paragraph (e)(2)(iii)(C) Example 2 of this section.

(C) Examples. The following examples illustrate the application of the safe harbor in paragraph (e)(2)(iii)(B) of this section:

Example 1. Multipurpose issue. In 2003, the issuer of a multipurpose issue uses brokers to acquire the following investments with gross proceeds of the issue: a guaranteed investment contract for amounts to be deposited in a construction fund (construction GIC), Treasury securities to be deposited in a yield restricted defeasance escrow (Treasury investments) and a guaranteed investment contract that will be used to earn a return on what otherwise would be idle cash balances from maturing investments in the yield restricted defeasance escrow (the float GIC). The issuer deposits $22,000,000 into the construction GIC and reasonably expects that no further deposits will be made over its term. The issuer uses $8,040,000 of the proceeds to purchase the Treasury investments. The issuer reasonably expects that it will make aggregate deposits of $600,000 to the float GIC over its term. The brokers' fees are $30,000 for the construction GIC, $16,080 for the Treasury investments and $3,000 for the float GIC. The issuer has not previously treated any brokers' commissions or similar fees as qualified administrative costs. The issuer may claim all $49,080 in brokers' fees for these investments as qualified administrative costs because the fees do not exceed the safe harbors in paragraph (e)(2)(iii)(B) of this section. Specifically, each of the brokers' fees equals the lesser of $30,000 and 0.2% of the computational base (or, if more, $3,000) (*i.e.*, lesser of $30,000 and 0.2% x $22,000,000 for the construction GIC; lesser of $30,000 and 0.2% x $8,040,000 for the Treasury investments; and lesser of $30,000 and $3,000 for the float GIC). In addition, the total amount of brokers' fees claimed by the issuer as qualified administrative costs ($49,080) does not exceed the per-issue safe harbor of $85,000.

Example 2. Cost-of-living adjustment. In 2003, an issuer issues bonds and uses gross proceeds of the issue to acquire two guaranteed investment contracts. The issuer pays a total of $50,000 in brokers' fees for the two guaranteed investment contracts and treats these fees as qualified administrative costs. In a year subsequent to 2003 (Year Y), the issuer uses gross proceeds of the issue to acquire two additional guaranteed investment contracts, paying a total of $20,000 in broker's fees for the two guaranteed investment contracts, and treats those fees as qualified administrative costs. For Year Y, applying the cost-of-living adjustment under paragraph (e)(2)(iii)(B)(3) of this section, the safe harbor dollar limits under paragraph (e)(2)(iii)(B)(1) of this section are $3,000, $32,000 and $90,000. The remaining amount of the per-issue safe harbor for Year Y is $37,059 ($90,000-[$50,000 x $90,000/$85,000]). The broker's fees in Year Y do not exceed the per-issue safe harbor under paragraph (e)(2)(iii)(B)(1)(ii) (as modified by paragraph (e)(2)(iii)(B)(3)) of this section because the broker's fees do not exceed the remaining amount of the per-issue safe harbor determined under paragraph (e)(2)(iii)(B)(6) of this section for Year Y. In a year subsequent to Year Y (Year Z), the issuer uses gross proceeds of the issue to acquire an additional guaranteed investment contract, pays a broker's fee of $15,000 for the guaranteed investment contract, and treats the broker's fee as a qualified administrative cost. For Year Z, applying the cost-of-living adjustment under paragraph (e)(2)(iii)(B)(3) of this section, the safe harbor dollar limits under paragraph (e)(2)(iii)(B)(1) of this section are $3,000, $33,000 and $93,000. The remaining amount of the per-issue safe harbor for Year Z is $17,627 ($93,000 - [($50,000 x $93,000/$85,000) + ($20,000 x $93,000/$90,000)]). The broker's fee incurred in Year Z does not exceed the per-issue safe harbor under paragraph (e)(2)(iii)(B)(1)(ii) (as modified by paragraph (e)(2)(iii)(B)(3)) of this section because the broker's fee does not exceed the remaining amount of the per-issue safe harbor determined under paragraph (e)(2)(iii)(B)(6) of this section for Year Z. See paragraph (e)(2)(iii)(B)(6) of this section.

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Par. 4. Section 1.148-11 is amended by revising paragraph (i) to read as follows:

§1.148-11 Effective dates.

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(i) Special rule for certain broker's commissions and similar fees. Section 1.148-5(e)(2)(iii) applies to bonds sold on or after February 9, 2004. In the case of bonds sold before February 9, 2004 that are subject to §1.148-5 (pre-effective date bonds), issuers may apply §1.148-5(e)(2)(iii), in whole but not in part, with respect to transactions entered into on or after December 11, 2003. If an issuer applies §1.148-5(e)(2)(iii) to pre-effective date bonds, the per-issue safe harbor in §1.148-5(e)(2)(iii)(B)(1)(ii) is applied by taking into account all brokers' commissions or similar fees with respect to guaranteed investment contracts and investments for yield restricted defeasance escrows that the issuer treats as qualified administrative costs for the issue, including all such commissions or fees paid before February 9, 2004. For purposes of §§ 1.148-5(e)(2)(iii)(B)(3) and 1.148-5(e)(2)(iii)(B)(6) (relating to cost-of-living adjustments), transactions entered

into before 2003 are treated as entered into in 2003.

Deputy Commissioner for Services and Enforcement.

Approved:

Assistant Secretary of the Treasury.