American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

August 13, 2013

Internal Revenue Service
CC:PA:LPD:PR (Notice 2013-4)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Possible Modifications to the Method by which Adjusted Applicable Federal Rates Are Determined (Notice 2013-4)

Dear Sir or Madam:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to provide comments regarding possible modifications to the method by which adjusted applicable Federal rates (adjusted AFRs) are determined. These comments were developed by the Corporations and Shareholders Technical Resource Panel and have been approved by the AICPA Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession with nearly 386,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

As explained in detail below, the AICPA understands that while the adjusted AFRs have multiple uses, which are discussed below, a principal use relates to the application of the section 382 limitation on the use of net operating losses (NOL) of corporations that have undergone an ownership change. Any change in methodology is likely to result in a lower limitation that, we believe, would be inconsistent with the purpose of section 382. In our comments below we suggest a separate approach to determining the long-term tax-exempt rate for purposes of the section 382 limitation.

With respect to other uses of the adjusted AFRs, the AICPA believes that, if a decision is made to change the methodology, it would be appropriate to base the new methodology on historic relationships between the yields for high quality taxable and tax-exempt obligations. We recommend that the historical data be used in a way that minimizes the effect of differences in credit quality. In our comments below, we describe one possible approach to a methodology for using the historic data.

Executive Summary

The AICPA recommends the fourth option proposed in Notice 2013-4, which uses the average percentage difference between the Federal long-term rates and the adjusted Federal long-term rates published between 1986 and 2007 with a modification. We propose the lowest individual tax rate, instead of the average percentage difference from the same period. The lowest individual tax rate should be the rate at which sufficient individual investors will be attracted to invest in tax-exempt bonds to clear the market supply of such bonds.

The AICPA recommends that the Internal Revenue Service ("Service") not change the current calculation methodology of the long-term tax-exempt rate for section 382 purposes. We also recommend a floor of 2.5% if the Service chooses to implement uniform calculation methodologies for the section 382 and section 1288 long-term tax-exempt rates.

Background

Section 1274(d) provides for applicable Federal rates (AFRs), which are used to determine the imputed principal amount of obligations to which section 1274 applies and the total unstated interest on obligations to which section 483 applies. The AFRs consist of a short-term rate, a mid-term rate, and a long-term rate. These are determined by personnel in the Department of Treasury and published every month in the Internal Revenue Bulletin.

Section 1288(b)(1) provides authority for regulations to modify the applicable federal rate for purposes of applying sections 1274 or 483 to a tax-exempt obligation. Under those regulations, "appropriate adjustments shall be made to the applicable Federal rate to take into account the tax exemption for interest on the obligation." The publication that contains the AFRs also contains adjusted AFRs, and these are treated as effecting the adjustment required by section 1288(b)(1).[1]

Section 382 contains limitations on the use of NOL carryforwards of corporations after an ownership change. The amount of the loss that can be used after an ownership change is limited to the value of the corporation immediately before the ownership change multiplied by the "long-term tax-exempt rate." Section 382(f) defines that rate as the highest of the adjusted Federal long-term rate for each of the months in the 3-calendar month period ending with the calendar month in which the ownership change occurs. The publication containing the AFRs and the adjusted AFRs also publishes the section 382 "long-term tax-exempt rate."

The adjusted AFRs are used for certain contingent payment debt instruments that pay tax-exempt interest. Tax-exempt interest amount is calculated based on the comparable yield methodology established by Treas. Reg. § 1.1275-4. The comparable yield methodology is further modified by providing that the "comparable yield for the obligation is the greater of the obligation's yield, determined without the contingent payments, and the tax-exempt applicable Federal rate that

[1] See Notice 2013-4, section II.A.

applies to the obligation."[2] Adjusted AFRs are also used to determine the maximum term of Qualified Zone Academy Bonds (QZABs).[3] In addition, administrative guidance has held that it is reasonable to use the adjusted applicable Federal long-term rate to determine substantially equal periodic payment distributions from an IRA.[4]

Notice 2013-4 describes the methodology used since 1986 to determine the adjusted AFRs under the following narrative.

Since 1986, the adjusted Federal long-term rate and each adjusted AFR have been determined by multiplying the corresponding AFR by a fraction (the "adjustment factor"). The numerator of the adjustment factor is a composite yield of the highest grade tax-exempt obligations available, which are prime, general obligation tax-exempt bonds. The denominator is a composite yield of U.S. Treasury obligations with maturities similar to those of the tax-exempt bonds. Each of the composite yields is measured over a one-month period.

In general, the fraction has been less than 1 and has resulted in adjusted AFRs that are less than the corresponding AFR. Since 2008, however, the fraction has often been greater than 1 and has resulted in adjusted AFRs that are greater than the corresponding AFR.

The current methodology is consistent with a statement in the Conference Report on the 1986 Act, which enacted the current version of section 382. The current methodology has results that are sometimes inconsistent with the purpose for using a tax-exempt rate as a component of the section 382 limitation. On the first point, as noted in Notice 2013-4, the Conference Report indicated that the long-term tax-exempt rate was to be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years. But more specifically, the Conference Report stated that the long-term tax-exempt rate would normally fall between a percentage of less than 100% of the AFR and 100% of the AFR. The report further stated that:

> . . . a rate lower than the long-term Federal rate is necessary to ensure the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation. Otherwise there would be a tax incentive for acquiring loss corporations.[5]

[2] Treas. Reg. § 1.1275-4(d)(3)(ii)(A).
[3] Treas. Reg. § 1.1397E-1(d). Section 1397E establishes QZABs as a category of tax-credit bonds. Sections 1397E(d)(1)(D) & (3) provide a maximum term limit for those bonds to the effect that the present value of the obligation to repay the principal on the bonds shall be equal to at least 50% of the face amount of the bonds. Those statutory provisions envisage that the discount rate used to determine present value will be based on "the average annual interest rate of tax-exempt bonds having a term of 10 years or more which are issued during the month [preceding the month of issuance of the QZABs]." Treas. Reg. § 1.1397E-1(d) implements that requirement by providing that the maximum term shall be determined using a discount rate equal to 110% of the long-term adjusted applicable Federal rate compounded semi-annually for the month in which the QZABs are sold.
[4] PLR 8911071.
[5] H.R. Report 99-841, at p. II-188.

AICPA Position

The AICPA believes that the published adjusted long-term tax-exempt rate often does not carry out the purpose for which it was created. The AICPA supports the initiative announced in Notice 2013-4 to change to a methodology that corrects the problems resulting from the deterioration of the credit quality of tax-exempt bonds, subject to the concern expressed below respecting the potential effect on the section 382 limitation.

The methodology suggested by the Conference Committee report and currently applied to the determination of the adjusted AFRs and the adjusted long-term tax-exempt rate assumed the existence of a pool of high credit quality tax-exempt bonds. For some years, the number of tax-exempt bond issuers with strong credit profiles (independent of credit enhancement) has been relatively small. Rather, high credit quality tax-exempt debt has generally been debt that has been credit enhanced, chiefly through bond insurance.[6] But many of the mono-line bond insurance companies have experienced significant problems with respect to their exposures to loan securitizations, through guarantees of credit default insurance and other financial contracts. The reduced availability of bond insurance seems to have resulted in insufficient numbers of the high quality municipal bonds needed for the current methodology to provide results consistent with the expectations underlying the methodology suggested by the Conference Committee report.

We also note a natural relationship between rates for taxable debt and rates for tax-exempt debt. In principle, the rates for tax-exempt debt should be lower than rates for taxable debt because of the exclusion from taxable income for interest on tax-exempt debt. The lower rates effectively operate as the equivalent of a tax in the sense that, for the marginal investor, the return on an investment in tax-exempt debt should be the same as the after-tax return on taxable debt. For example, an investor with a marginal tax rate of 28% will view investment in a tax-exempt bond as equally attractive to investment in a taxable bond only if the yield on a comparable tax-exempt bond is no less than 72% of the yield on the taxable bond. Historically, the rate relationship has been less than would be indicated if the marginal investor was taxed at the highest corporate or individual tax rate. At a marginal taxable rate of 35%, the yield for a comparable tax-exempt bond could be as low as 65% of the yield on the taxable bond. Instead, the rate relationship has been much narrower,[7] which indicates that it has been necessary, in order to clear the market supply of tax-exempt bonds, for some of the bonds to be purchased by individual investors in lower rate brackets.

The AICPA believes that the new methodology should be based on that natural relationship.

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[6] See PIMCO, A New Paradigm for Municipal Bond Investing, http://investments.pimco.com/insights/External%20Documents/A_New_Paradigm_for_Municipal_Bond_Investing_PWP003.PDF; Investopedia, Fatal Seduction of the Municipal Bond Industry (Feb. 26, 2009), http://www.investopedia.com/articles/bonds/08/municipal-bond-insurance.asp .

[7] See Bond Buyer, Muni-Treasury Yield Ratio Returns to 100% (May 30, 2013), http://www.bondbuyer.com/issues/118_24/-299151-1.html.

AICPA Recommendations

The AICPA recommends that the new methodology should use historic data to determine the lowest individual marginal tax rate needed to attract investors sufficient to clear the market supply of tax-exempt bonds. That lowest individual marginal tax rate bracket cannot be defined simply as the rate bracket with so many rate brackets below the maximum rate bracket, as the structure of rate brackets may vary from time to time. We believe that the historic data suggested in our recommendation should consider sufficient numbers of individual taxpayers that are in the pool of individual taxpayers for whom the return on tax-exempt bonds and the after-tax return on taxable bonds during the period in question. The published Statistics of Income identify the number of returns by marginal rate bracket.[8] Adding the number of returns at that lowest marginal rate bracket to the number of returns in higher rate brackets would provide an indication of the absolute number and relative percentage of taxpayers included in the potential investor pool of persons for whom the tax-exempt bond investment was equally attractive to an investment in a taxable bond (or more attractive in the case of taxpayers with higher marginal tax brackets). If the rate bracket structure changes, the methodology would identify the current rate bracket at which comparable numbers of taxpayers would find a tax-exempt bond investment at least as attractive, on an after-tax basis, to a taxable bond investment.

The initial analysis of the historical data would be somewhat laborious but would not have to be repeated; and an adjustment to the ratio of tax-exempt to taxable yields would have to be made only in the case of changes in the rate bracket structure. The fourth new methodology option set forth in Notice 2013-4 would use "an adjustment factor based on the average percentage difference between the Federal long-term rates and the adjusted Federal long-term rates published between 1986 and 2007." Our recommendation modifies that approach to use historic data, but not to directly establish a static percentage difference between the AFRs and the adjusted AFRs. Instead, it would use the historic data to identify the lowest individual tax rate at which sufficient individual investors will be attracted to invest in tax-exempt bonds to clear the market supply of such bonds. Consequently, our recommendation would inform the identification of the equivalent individual tax rate bracket for the current taxable year. This requires a year-by-year analysis rather than an averaging of the rate relationships over a number of years.

The annual percentage difference between the AFRs and the adjusted AFRS from 1986 and 2007 may be the best historic data source that eliminates factors other than credit quality that could affect the rate differential. However, the AFR data base is not necessarily the best historic data base. Consideration could be given to other data bases, such as the Bond Buyer index, if they have comparable time-period coverage and an appropriate methodology to eliminate credit quality effects. Moreover, if economic and market conditions normalize, the methodology could replace or supplement the older historic data with current data.

For section 382 purposes, we propose that the Service not change the calculation methodology of

[8] See Individual Income Tax Rates and Shares, 2010, Schedule C, in Statistics of Income Bulletin (Winter 2013), at p. 23.

the long-term tax-exempt rate. The legislative history of section 382 indicates that Congress did not envision a scenario in which taxpayers did not have alternative investment options (similar to the current market). Because of this, we believe that the legislative history merely provides the background regarding the concerns Congress was attempting to address at that time of enactment. However, we believe the legislative history is not instructive as to whether the Service should change the calculation methodology of the long-term tax-exempt rate. Therefore, we would propose leaving the calculation methodology as is with respect to section 382.

We note that the Service may prefer to have uniform calculation methodologies for the section 382 and section 1288 long-term tax-exempt rates. While it is not our preferred approach, if that is the case, then we would propose to modify the calculation methodology for section 382 purposes in a similar manner as the manner described above, but subject such calculation to a floor of 2.5%.[9] We believe the establishment of a floor is imperative because of the primary purpose of section 382: the prevention of loss trafficking by deferring (as opposed to eliminating) the utilization of a taxpayer's "pre-change" NOLs. Pursuant to section 172(b), a taxpayer can only carry forward a NOL for 20 taxable years. Therefore, if the section 382 long-term tax-exempt rate is below 5%, then a portion of a taxpayer's NOLs will generally expire before their complete utilization. While we recognize that our proposed 2.5% floor rate would generally prohibit a taxpayer from utilizing 50% of its NOLs at the time of the ownership change (which is why we would prefer a high floor such as 5%), it is also reflective of the current market conditions and we believe this is an equitable remedy to address the Service's concerns.

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We appreciate your consideration of these comments. If you have any questions regarding this submission, please feel free to contact Todd Reinstein, chair of the AICPA Corporations and Shareholders Technical Resource Panel[10], at (202) 220-1520, or reinstet@pepperlaw.com; or Jason Cha, AICPA Technical Manager, at (202) 434-9231, or jcha@aicpa.org.

Respectfully submitted,

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Chair, AICPA Tax Executive Committee

[9] Based on our review of the past long-term tax-exempt rates that applied for section 382 purposes, we believe that this floor is below the lowest adjusted federal long-term tax-exempt rate that has applied since section 382 was first enacted.

[10] The Corporations and Shareholders Technical Resource Panel would like to thank Dale Collinson for his contributions to this letter.

cc: Steven Harrison, Office of Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service