PHONE 202-503-3300 601 Thirteenth Street, NW
FAX 202-637-0217 Suite 800 South
www.nabl.org Washington, D.C. 20005

February 1, 2019

Charles P. Rettig
Commissioner
Internal Revenue Service
U.S. Department of the Treasury
1111 Constitution Avenue, NW Washington, DC 20224

David J. Kautter
Assistant Secretary
Office of Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

William M. Paul
Acting Chief Counsel
Internal Revenue Service
U.S. Department of the Treasury
1111 Constitution Avenue, NW
Room 3026
Washington, DC 20224

Re: *Recommended Remediation Proposals Including Comments on Revenue Procedure 2018-26*

Dear Mr. Rettig, Mr. Kautter, and Mr. Paul:

The National Association of Bond Lawyers (NABL) respectfully submits this set of comments and proposals for consideration by the United States Department of the Treasury and the Internal Revenue Service with respect to Treasury Regulation §1.141-12 and Revenue Procedure 2018-26 governing remedial actions.

The enclosed comments were prepared by an ad hoc task force comprising the individuals listed on Appendix A and were approved by the NABL Board of Directors.

If NABL can provide further assistance, please do not hesitate to contact Jessica Giroux, Director of Governmental Affairs in our Washington DC office, at (202) 503-3290 or at jgiroux@nabl.org.

Sincerely,

Dee P. Wisor

Dee P. Wisor
President, National Association of Bond Lawyers

CC:

John J. Cross, III, Associate Tax Legislative Counsel, Office of Tax Policy, U.S. Department of the Treasury

Helen M. Hubbard, Associate Chief Counsel, Financial Institutions and Products, Internal Revenue Service

Christie Jacobs, Director, Indian Tribal Governments/Tax Exempt Bonds, Internal Revenue Service

Timothy Jones, Senior Counsel, Branch 5, Internal Revenue Service

Johanna Som de Cerff, Senior Technician Reviewer, Office of Chief Counsel, Internal Revenue Service

Zoran Stojanovic, General Attorney, U.S. Department of the Treasury, Internal Revenue Service

Krishna Vallabhaneni, Acting Tax Legislative counsel, Office of Tax Policy, U.S. Department of the Treasury

Executive Summary

Current regulations have interpreted code requirements that proceeds "are to be" used in a private trade or business as satisfied if either the private use is expected at closing, or an unexpected deliberate action that causes private use is not remediated. The ability of bond issuers (and conduit borrowers) to remediate unexpected private use allows issuers to make economically prudent decisions regarding facilities financed with outstanding bond issues.[1]

On April 11, 2018, the Internal Revenue Service released Rev. Proc. 2018-26, 2018-18 IRB 546, which expanded the availability of certain remedial actions under Treas. Reg. §1.141-12. This Revenue Procedure was designed in part to facilitate private investment in facilities previously financed with tax-exempt bonds. Such privatization of public facilities has been viewed by many as the best way of maintaining and improving America's infrastructure. The strong interest in public private partnerships has increased the tension between rules that might otherwise deter economically desirable structures and rules that prevent a burdening of the tax advantaged bond market. We strongly encourage any guidance that serves to allow local governments to prudently manage their bond financed facilities while protecting the federal government's interests and the tax advantaged bond market. We believe that Rev. Proc. 2018-26 was a step in the right direction and provides much needed relief in this area.

We do however, as described in this submission, have some recommendations to improve and clarify the Revenue Procedure. We also request additional changes to the Revenue Procedure or other guidance under Treas. Reg. §1.141-12 to make remediation of previously unexpected private use of tax-exempt bond financed facilities and other unexpected violations less expensive. We believe that this can be accomplished under the authority provided to the Commissioner under Treas. Reg. §1.141-12(h) without significant cost to the United States and without harm to the stated policies for tax-advantaged bonds.

Treas. Reg. §1.141-12(h) provides the Commissioner with authority to provide additional remedial actions including remedial actions involving payments to the IRS to cure violations not expected at closing. The authority provided by this regulation is broad and certainly covers Rev. Proc. 2018-26. Additionally, we believe that it provides sufficient authority to implement all of our proposals through additional revenue procedures or similar pronouncements and would not require modification of any regulations.

Parts I and II of our proposal set forth NABL's recommendations with respect to Rev. Proc. 2018-26. We suggest that Treasury (1) eliminate the double remediation that seems to be currently required by Rev. Proc. 2018-26 in the context of the remediation via removal of the tax advantage, (2) expand anticipatory remediation to apply to all permitted remedial actions, (3) make rules more consistent to avoid needless complexity, (4) limit required remediation to the amount of available funds created by the violation, (5) make the yield reduction mechanism of the Revenue Procedure more consistent with the arbitrage rules (and clearer at the same time), (6) modify the trigger for

1 This ability to remediate unexpected violations also applies in other contexts including rules applicable to long term working capital borrowings.

determining when nonqualified use occurs to be more consistent with Treas. Reg. §1.141-12 and (7) clarify the determination of the amount of nonqualified bonds resulting from a nonqualified use.

In addition to our specific comments on Rev. Proc. 2018-26, we propose that Treasury (1) eliminate current expensive requirements, such as defeasance escrows, that do not further the purpose of the remediation provisions, (2) expand the remedial action provisions to allow remediation of private payments, (3) add direct payment to the United States Treasury of taxpayer exposure as an alternative to redemption of nonqualified tax-exempt bonds, (4) expand anticipatory remedial action to cover all types of remediation otherwise available and (5) provide more flexible remediation when a change in use preserves public access and some control over the financed facilities following the change in use.

We recommend a new remedial action be adopted with respect to financed facilities that are unexpectedly privately used in a manner that preserves public access, ownership and control of rates and charges. This proposal follows a suggestion of the "Legislative Outline for Rebuilding Infrastructure in America" released by the White House in February 2018.

PART I

Comments Concerning Revenue Procedure 2018-26 Special Remedial Actions for Direct Pay and Tax Credit Bonds

Sections 6 and 7 of Rev. Proc. 2018-26, 2018-18 IRB 546 provide remedial action rules that are generally specific to direct-pay and tax-credit bonds. Section 6, Remedial Action for Direct Pay Bonds to Reduce the Refundable Tax Credit (*"Subsidy Reduction"*), applies only to direct-pay bonds, and Section 7, Certain Remedial Actions for Tax-Advantaged Bonds, provides two alternative remedial actions for direct-pay and tax-credit bonds (*"2018 Redemption/Defeasance"* and *"2018 Alternative Use"*).[2]

The rules of Sections 6 and 7 of the revenue procedure overlay previously existing remedial action rules that may apply to these bonds. This means that issuers of direct-pay and tax-credit bonds subject to private use limitations (*e.g.* BABs) will use Treas. Reg. §1.141-12, rather than Section 7 of Revenue Procedure 2018-26, to cure private use and private loan excesses, and issuers of QZABS issued under Code §1397E must use the remedial action rules provided in Treas. Reg. §1.1397-1(h)(8) (other than to correct long-term leases).[3]

2018 Alternative Use is found in Section 7.05 of the Revenue Procedure and is, for requirements other than private use and private loan limitations, analogous to the alternative use remedial action of Treas. Reg. §1.141-12(e). Disposition proceeds are applied to an alternative use that meets the relevant Code requirement.

2018 Redemption/Defeasance is found in Section 7.02 of the Revenue Procedure and is, for requirements other than private use and private loan limitations, analogous to the redemption or defeasance remedial action of Treas. Reg. §1.141-12(d).

Subsidy Reduction is available only for direct-pay bonds. It can be used to remediate private use and private loans in addition to other unexpected Code violations. It has no direct analogue under Treas. Reg. §1.141-12 but rather directly stops or reduces the tax credits otherwise available to issuers of direct-pay bonds.

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2 The provision in Revenue Procedure 2018-26, Section 7.02(2) that allows issuers to elect between yield restricting the defeasance escrow and paying arbitrage rebate on escrow earnings is available for issuers under Treas. Reg.§1.141-12(d).

3 However, section 7.02 concerning yield restriction can be applied to defeasance escrows established under Treas. Reg. §1.141-12(d) and §1.142-2(c). Issuers of BABs can, of course apply Section 6 of the Revenue Procedure to reduce the subsidy rather than applying Treas. Reg. §1.141-12.

A. Subsidy Reduction Comments

Subsidy Reduction allows an issuer to remediate by: 1) reducing the refundable tax credit to eliminate the amount allocable to the nonqualified bond (*"Subsidy Reduction"*); and 2) treating the disposition proceeds (defined to mean all amounts received from the disposition and investment earnings thereon) as gross proceeds for Code §148 *and as proceeds for the "applicable Code section,"* defined to mean the Code section that sets forth the qualification requirements for a particular type of bond (a *"qualifying use"*). The issuer reduces or terminates the subsidy by: 1) beginning with the first Form 8038-CP (Return for Credit Payment to Issuers of Qualified Bonds) (or successor form) filed for any interest payment date for the bonds after the nonqualified use occurs, reporting the amount of interest payable by excluding the portion of the interest allocable to the nonqualified bonds that accrues on or after the date of the nonqualified use; and 2) for the first such Form 8038-CP or successor form, providing a revised debt service schedule reflecting the exclusion of amounts allocable to the nonqualified bonds beginning with the date of the nonqualified use.

Because issuers of direct-pay bonds are the direct recipient of the tax subsidy, it is easy for these issuers to terminate the subsidy on nonqualified bonds by not claiming refundable tax credits for interest payable on those bonds on future Forms 8038-CPs. Further, when the issuer submits a new debt service schedule reflecting interest on only the remaining qualified bonds, as is required in Section 5 of Revenue Procedure 2018-26, the IRS is easily able to identify a future Form 8038-CP that erroneously claims a subsidy for interest that exceeds what was reported on the revised debt service schedule. Thus, the approach taken in Section 5 is an appropriate and effective way for issuers of direct-pay bond to eliminate the subsidy on the nonqualified bonds. This approach eliminates what may otherwise be a costly redemption. Many direct pay bonds have "make whole" call provisions that can produce a very high redemption premium when prevailing interest rates exceed the rate on the bond. Eliminating the subsidy while leaving the bond (without any tax advantage) outstanding saves issuers considerable sums.

1. Comments on Double Remediation

Under Section 7.02(3) of the Revenue Procedure, if an issuer remediates tax-advantaged bonds through Subsidy Reduction or 2018 Redemption/Defeasance, any disposition proceeds must be treated as "gross proceeds for purposes of § 148 as modified by the applicable Code section (the arbitrage requirements) *and as proceeds for purposes of the applicable Code section*." (Emphasis added). The *"applicable Code section"* is defined to mean the Code section that sets forth the qualification requirements for a particular type of bond (a *"qualified use"*).

Consistent with the treatment under Treas. Reg. §1.141-12, any disposition proceeds must under Section 7.02(3) of the Revenue Procedure be treated as gross proceeds for arbitrage purposes. This means that such disposition proceeds are subject to arbitrage yield restriction and rebate until such amounts are allocated to an expenditure (unless a separate exception applies). This treatment as "gross proceeds" is appropriate because investing such amounts above the yield on the bonds would provide arbitrage benefits by exploiting the differences between the tax advantaged and taxable markets.

We are concerned, however, about the further requirement of Section 7.02(3) of the Revenue Procedure, that an issuer use the disposition proceeds for a "qualified use." As further discussed below, the addition of the qualified use requirement significantly undercuts the usefulness of this remedial action because issuers applying Subsidy Reduction would have to take two remedial action measures to cure a single problem ("duplicate remedial action"), as compared to other issuers and other types of remedial actions. Issuers of tax-exempt bonds may remediate by terminating the subsidy on the nonqualified bonds **or** by using the disposition proceeds for an alternative qualified use.

Issuers of tax-exempt bonds also can, under Treas. Reg. §1.141-12(d), cure noncompliance by terminating the subsidy. Because issuers of tax-exempt bonds are not the direct recipient of the tax subsidy on those bonds, however, they can only terminate the subsidy indirectly, such as by redeeming the nonqualified bonds.[4] Treas. Reg. §1.141-12(d) recognizes this and allows an issuer to cure noncompliance by redeeming nonqualified bonds. Unlike Section 6 of Rev. Proc. 2018-26, an issuer that redeems (or defeases) its nonqualified bonds under Treas. Reg. §1.141-12(d) is not also required to use the disposition proceeds for another qualified use.

While it might be appealing to attribute the lack of a further requirement for the disposition proceeds in the case of redemptions under Treas. Reg. §1.141-12(d) to the fact that the issuer has effectively spent those proceeds by using the proceeds to redeem the bonds (*i.e.*, the proceeds and subsidy are gone), this logic fails to apply in many redemption remedial action situations involving tax-exempt bonds.[5] For example, if the issuer instead of using the disposition proceeds uses proceeds of taxable bonds to redeem the tax-exempt bonds, the issuer still has no limitation on its use of the disposition proceeds. The noncompliance is cured for tax-exempt bonds even though the issuer retains the disposition proceeds. The amount needed to retire the nonqualified bonds may be more or less than the disposition proceeds.[6] Certainly, this issuer faces increased interest costs because it now pays interest at a taxable rate, but this cost is realized over time and may not equate to the amount of the disposition proceeds. This result makes sense because proceeds allocable to the nonqualified bonds are no longer allocable to tax-exempt bonds.[7]

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4 In the case of a private placement tax-exempt bond issue, the issuer could negotiate a new taxable rate applicable to the bond, while leaving the bond outstanding under the documents. However, for tax purposes, such a modification would in most cases trigger a reissuance of the bonds, effectively causing the bonds to be treated as redeemed.

5 The double remediation concern also applies to 2018 Redemption or Defeasance. Any argument that the disposition proceeds have already been spent and therefore are not affected by the double remediation requirement is also inappropriate in the context of 2018 Redemption or Defeasance.

6 Disposition proceeds can be more than the amount needed to redeem nonqualified bonds either because the financed facilities increased in value or because bonds allocable to the facility have already been retired before the change in use.

7 Generally, under Treas. Reg. §1.141-12(c)(2) and (i)(3), after disposition, the proceeds of the issue allocable to the transferred property (*i.e.*, the nonqualified use) are treated as financing the disposition proceeds, and once remedial action is taken, the amount of disposition proceeds is treated as equal to the proceeds of a separate issue of nonqualified bonds issue that had been allocable to the transferred property before the

Alternatively, under Treas. Reg. §1.141-12(e), an issuer of tax-exempt bonds that receives cash disposition proceeds may cure noncompliance by using the disposition proceeds for an alternative permitted use. This regulation section does not also require the issuer to eliminate the tax subsidy on bonds allocable to those disposition proceeds (provided the issuer reasonably expects to and does spend the disposition proceeds for the alternative qualified use in two years.)

If an issuer disposes of bond financed property, it is generally appropriate to treat the bond issue as financing **either** the transferred (disposed) property **or** the disposition proceeds (and hence the replacement property on which it is spent).[8] Even if an issuer fails to meet the requirements for taking a remedial action, Treas. Reg. §1.141-12(c)(2) provides that the proceeds are allocable to **either** the transferred (disposed) property **or** the disposition proceeds, whichever allocation produces the greater amount of private business use and private security or payments.

The regulatory policy is that the tax subsidy on the bonds continues to be merited because the proceeds allocable to those the bonds continue to be used in a qualifying manner. An issuer of tax-exempt bonds generally may cure noncompliance by reducing the subsidy (through bond redemption) or by using the disposition proceeds for another qualified use but is generally not required to do both.

Subsidy Reduction penalizes issuers using this remedial action because it requires the issuer to reduce the subsidy ***and*** *use the disposition proceeds for a qualifying use.*

Rev. Proc. 2018-26, by requiring that an issuer use the disposition proceeds for a qualified use in addition to reducing the subsidy allocable to the nonqualified bonds associated with the disposition, treats the issue as financing **both** the disposed property **and** the disposition proceeds.[9] This is contrary to the current regulations and the purpose of the remediation provisions and is also unduly burdensome on the issuer.

When an issuer of direct-pay bonds terminates or reduces the subsidy, it is effectively in the same place as the issuer of tax-exempt bonds that redeems nonqualified bonds by refunding those bonds with taxable bonds. In both cases, 1) the issuers retain the disposition proceeds, 2) the issuers are required to fully fund the taxable interest payments on the nonqualified bonds until those bonds are fully paid, 3) the issuers' increased interest costs may or may not equal the amount of the disposition proceeds, and 4) most importantly, the proceeds allocable to the nonqualified bonds are no longer allocable to tax-advantaged bonds. Accordingly, an issuer that eliminates the subsidy under Subsidy Reduction should be treated similarly to the issuer that eliminates the

disposition. In other words, by redeeming the nonqualified bonds, all of the disposition proceeds are now allocable to the redeemed bonds.

8 *See* TD 8712 and Treas. Reg. §1.141-12(c)(2).

9 Alternative qualified use of disposition proceeds might not even be possible. For example, proceeds of an NCREB are required to be spent on projects that have been approved. If no such projects remained, how could disposition proceeds be spent on such a project?

subsidy by redeeming the nonqualified bonds with taxable bonds, and it should not have additional requirements on how it uses disposition proceeds.

Alternatively, when an issuer of direct-pay bonds uses the disposition proceeds for a qualified use, the bonds allocable to that qualified use still merit the tax subsidy. Subsidy Reduction fails to recognize this even for those situations that would clearly be within Treas. Reg. §1.141-12(e) if the bonds were tax-exempt bonds. This means that, unless a different remedial action is available, even if the issuer of direct-pay bonds receives cash disposition proceeds and expects to and does use those proceeds within two years for a qualified use, it must still eliminate the tax subsidy on the bonds. While an issuer may have the option to use the 2018 Alternative Use or Treas. Reg. §1.141-12(e) (for private loan or private use violations),[10] the existence of the option does not negate the fact that the duplicate remedial action required with Subsidy Reduction severely undercuts the usefulness of that otherwise simple and effective remedial action.

2. Comments on Anticipatory Remediation

Subsidy Reduction should allow issuers of direct-pay bonds the same flexibility as issuers of tax-exempt bonds by permitting anticipatory remedial action.

Issuers of tax advantaged bonds, including tax-exempt bonds may take anticipatory remedial action under Treas. Reg. §1.141-12(d)(3) to cure possible future private use or private loans through redemption or defeasance of nonqualified bonds. The issuer applies this rule by adopting an official intent statement that the bonds it is redeeming or defeasing would become nonqualified upon a subsequent deliberate action and redeems or defeases those bonds no later than 90 days of that subsequent deliberate act. Importantly, excess private use (or private loan) need not have occurred at the time of the redemption or defeasance. Anticipatory remedial actions under Treas. Reg. §1.141-12(d)(3) are often used to allow an issuer to stop tracking private use of a facility before the private use begins. This can be helpful, for example, when an issuer transfers ownership or control over a bond financed facility to another governmental entity, so that the issuer no longer controls the facility's use.

In the case of defeasance of bonds that will not be paid until after the change in use occurs (or up to 90 days later), the defeasance would qualify as a remedial action without application of Treas. Reg. §1.141-12(d)(3). But, if the nonqualified bonds are redeemed before the private use limits are exceeded, the anticipatory remediation concept is essential because the amount of nonqualified bonds would (without application of the anticipatory remediation concept) be based on a percentage of the bonds then outstanding, and full credit would not be given to bonds redeemed before that date.

Rev. Proc. 2018-26 does not provide a similar anticipatory remedial action rule for Subsidy Reduction (or 2018 Redemption or Defeasance). For the reasons noted above, NABL believes that an issuer that remediates through Subsidy Reduction should be treated no worse than the issuer of tax-exempt bonds that remediates by redeeming nonqualified bonds by refunding those bonds

10 The issuer would still be required to use investment earnings on the disposition proceeds for the qualified use, which does not appear to be required under Treas. Reg. §1.141-12(e).

with taxable bonds. Accordingly, NABL believes that Subsidy Reduction can and should be modified to allow issuers to take anticipatory remedial action.[11] Such remedial action could be accomplished in the same manner as Treas. Reg. §1.141-12(d)(3); that is, with an official statement of intent followed by a subsidy reduction beginning no later than when the nonqualified use occurs. The subsidy would be reduced through the Form 8038-CP next filed after the effective date of the anticipatory remedial action, which would be no later than when the nonqualified use occurs (but might be earlier). The issuer, on that form, would claim the subsidy for the nonqualified bonds only for a period ending while the bonds were known to be qualified and include a new debt service schedule reflecting interest payable on only the bonds known to be qualified bonds.[12]

Treas. Reg. §1.141-12 requires the statement of intent for anticipatory redemption or defeasance in order to ensure that the redemption or defeasance is related to the nonqualified use and not, for example, a redemption or defeasance already scheduled under the original terms of the bond or for reasons unrelated to a change in use. The Treasury and IRS should be comfortable that the Subsidy Reduction is related to anticipated nonqualified use because the issuer is only requesting a change (reduction) to the subsidy for its debt service and is not changing its required debt service payments. While there are many reasons that an issuer may redeem bonds early that are unrelated to tax covenants, the same cannot be said of a voluntary reduction in a tax subsidy taken. Economically, such a reduction cannot benefit the issuer except to assist in tax compliance.

Any bonds in the issue for which the debt service has been removed from the debt service schedule should be treated as redeemed for purposes of remedial actions, and for the reasons described above, no further requirement should be imposed on the issuer with respect to use of the disposition proceeds on the then unsubsidized "redeemed bonds."

NABL recommends the following changes to the Subsidy Reduction Rule:

- Allow an issuer of direct-pay bonds to reduce the subsidy without the additional requirement for qualified use of the disposition proceeds; and
- Expand Subsidy Reduction to allow anticipatory remedial action

B. 2018 Redemption/Defeasance Comments

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11 NABL believes that anticipatory remediation should be available for all methods of remediation. See Part VI of these Comments for more general comments on anticipatory remediation.

12 An issuer could remove the subsidy on the entire direct-pay bond issue simply by filing a Form 8038-CP that identifies that return as the last return for which the issuer will claim a refundable tax credit. NABL believes this could be done with a change to the instructions that would allow the issuer to identify the return as the final return for which a subsidy will be claimed whether or not interest remains payable on the bonds and whether or not a deliberate action has yet occurred. For returns so identified, because the IRS will have internally "flagged" that bond issue as not entitled to further refundable tax credit payments, the IRS could easily identify any erroneously filed Form 8038-CP for that bond issue that is filed after the "final return" is filed. In the case of a partial anticipatory redemption, the instructions could require attachment of a replacement schedule of future subsidies that would reflect the anticipatory remedial action.

NABL strongly agrees that issuers of direct-pay bonds and tax-credit bonds should be able to cure noncompliance through redemption and/or defeasance of nonqualified bonds. NABL further commends the Treasury and IRS for providing issuers of tax-advantaged bonds with the ability to elect between yield restricting the defeasance escrow and making payments to the IRS to reduce the yield on the escrow.[13] We recommend, however, some improvements to 2018 Redemption/Defeasance, described below.

1. Comments Related to Consistency with Regulatory Provisions

Rules applicable to redemption and defeasance remedial actions should be consistent and not depend on the type of nonqualified use. Issuers of tax-credit and direct-pay bonds under Rev. Proc. 2018-26 apply different redemption and defeasance rules depending upon the type of noncompliance, which creates a trap for the unwary.

Issuers of direct-pay and tax-credit bonds that choose to redeem or defease their bonds have to apply different rules depending on what action is being remediated. The issuer must use one set of rules (Treas. Reg. §1.141-12(d)) to cure private use or private loan violations under Code §141, if applicable, and another set of rules (2018 Redemption/Defeasance) to cure other violations. For example, an issuer that wants to cure private use or private loan violations may redeem or defease the bonds under the anticipatory remedial action rule, whereas it must wait until the deliberate action happens that causes noncompliance before it may cure other types of violations. Similarly, an issuer that receives all cash disposition proceeds and wants to cure private use or private loan violations would be required only to redeem or defease a portion of the nonqualified bonds equal to the amount of the disposition proceeds, whereas the same issuer that wants to cure other noncompliance must redeem or defease all of its nonqualified bonds and apparently, use the disposition proceeds not used to redeem or defease the bonds for a qualified use. Further, to apply redemption and defeasance under Treas. Reg. §1.141-12(d), certain prerequisites apply, and the issuer must provide notice to the IRS of a defeasance escrow, if applicable. Not all of these prerequisites and rules apply to 2018 Redemption and Defeasance.[14] This dual structure creates a trap for the unwary and should be eliminated to the extent possible. Discussed below are additional recommendations providing uniformity to these rules.

2. Comments Related to Partial Defeasance or Redemption on Nonqualified Bonds with Disposition Proceeds

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13 See Part III of these Comments for more general comments concerning the need to establish a defeasance escrow to accomplish remediation.

14 For example, Treas. Reg. §1.141-12(d)(5) only permits a defeasance if the bonds, when issued had no more than 10 ½ years of call protection. Section 7.02 or the Revenue Procedure has no such requirement. Treas. Reg. §1.141-12(d)(4) requires written notification of the IRS when a defeasance escrow is established. Section 7.02 or the Revenue Procedure has no such requirement. The investment restrictions on the defeasance escrow are essentially the same. (Certain Qualified Zone Academy Bonds are subject to Treas. Reg. §1.1397E-1(h)(8), which cryptically provides that at least 90% of the weighted average amount in the defeasance escrow must be invested in investments.)

2018 Redemption/Defeasance should allow issuers receiving cash disposition proceeds that are less than the amount of nonqualified bonds to redeem a pro-rata portion of the nonqualified bonds.

Issuers of tax-exempt, tax-credit, and direct-pay bonds that receive cash disposition proceeds and remediate under Treas. Reg. §1.141-12(d) may redeem a pro-rata portion of the nonqualified bonds (the "*pro rata rule*") if the cash received as disposition proceeds is insufficient to redeem or defease all of the nonqualified bonds. Similarly, Treas. Reg. §1.1397E-1(h)(8)(B)(2) provides that if the nonqualified use of QZABs arises because of disposition of certain property and that disposition is for cash, the issuer will have remediated if it used all of the disposition proceeds to redeem or defease the nonqualified bonds. NABL believes issuers of tax-credit and direct-pay bonds should have the same treatment when they remediate other nonqualified use under 2018 Redemption/Defeasance, but receive insufficient funds from the deliberate action to redeem all of the nonqualified bonds.

3. Comments Related to Full Defeasance or Redemption on Nonqualified Bonds Notwithstanding Excess Disposition Proceeds

2018 Redemption/Defeasance should provide that an issuer has cured nonqualified use by redeeming or defeasing nonqualified bonds, even if the disposition proceeds exceed the amount of nonqualified bonds.

Issuers of tax-exempt, tax-credit, and direct-pay bonds subject to Treas. Reg. §1.141-12(d) may cure noncompliance by redeeming or defeasing nonqualified bonds; even if the disposition proceeds exceed the amount of the nonqualified bonds ("excess disposition proceeds"), the issuer has no obligation to use the excess disposition proceeds for an alternative qualified use. Issuers applying Section 7 of the Revenue Procedure have a different result because Section 7 requires the issuer to redeem the nonqualified bonds and use all of the disposition proceeds for qualified use (presumably this would apply only to the disposition proceeds that were not used to redeem or defease the nonqualified bonds). NABL believes issuers of tax-credit and direct-pay bonds should have the same treatment for all nonqualified use and believe the rule in Treas.Reg. §1.141-12(d) should apply to 2018 Redemption/Defeasance. As stated earlier, there is no need for double remediation. As under Treas. Reg. §1.141-12(d) disposition proceeds should be treated as gross proceeds for arbitrage purposes but should not otherwise be treated as proceeds of the bond issue subject to any use restriction.

4. Comments Related to Anticipatory 2018 Redemption/Defeasance

2018 Redemption/Defeasance should allow issuers of direct-pay and tax-credit bonds to take anticipatory remedial action.

As discussed above, issuers of tax-exempt, tax-credit, and direct-pay bonds applying Treas. Reg. §1.141-12(d)(3) are permitted to use anticipatory remedial action under that redemption/defeasance rule. 2018 Redemption/Defeasance does not have a similar rule. NABL believes issuers of tax-credit and direct-pay bonds should have the same treatment for all nonqualified use and believe the rule in Treas. Reg. §1.141-12(d) should apply to 2018

Redemption/Defeasance. Further, for direct-pay bonds, we have discussed an alternative mechanism that may be used to take anticipatory remedial action under Subsidy Reduction.

NABL recommends the following changes to the 2018 Redemption/Defeasance Rule:

- To the extent possible, provide a consistent set of redemption and defeasance rules for direct-pay and tax-credit bonds for all nonqualified use, including;
    - Provide a special rule for all cash disposition proceeds that allows a pro-rata portion of nonqualified bonds to be redeemed/defeased;
    - Limit remediation of disposition proceeds to redemption or defeasance of nonqualified bonds even if the disposition proceeds exceed the amount of nonqualified bonds;
    - Allow anticipatory remedial action;
    - Apply the 10 ½ year call protection rule to all defeasance remediations where bonds are not redeemed in 90 days; and
    - Make the notification requirement equally applicable to the establishment of any defeasance escrow for remedial purposes.[15]

C. Rebate and Yield Restriction Comments

2018 Redemption/Defeasance should provide more guidance on how arbitrage rebate is computed under Section 7.02(2) for variable rate issues.

Section 7.02(2) permits an issuer of tax-advantaged bonds to either restrict the investments in the defeasance escrow to investments that are not higher yielding investments (as defined in §148(b)) or make rebate payments to the United States, at the same time and in the same manner as arbitrage rebate amounts are required to be paid, in amounts equal to any earnings on investments in the defeasance escrow that are higher than the yield on the issue with respect to which the defeasance escrow was established. For this purpose, the computation period is deemed to start on the date the escrow is created, which for variable rate bonds is unlikely to occur on a computation date for which the yield is determined under general rebate and yield restriction rules. Although Section 7.02(2) provides that compliance with the revenue procedure is treated as providing compliance with all arbitrage restrictions, there is no guidance on how to incorporate the payments made under Section 7.02(2) of the Revenue Procedure with the payments required under Code § 148(f). The bond yield applicable under Section 7.02(2) may be different from the bond yield applicable under Code § 148. Furthermore, the bond yield applicable under Section 7.02(2) may not be determinable until the end of the computation period beginning when the escrow is established, a date that may occur well after the end of the escrow and after the due date

15 We fail to see the utility of requiring notification to the IRS of the establishment of any defeasance escrow. We note that the IRM provides for a small settlement amount applicable to missed notifications, indicating that the IRS also believes that such notification is not of great importance. While the notification requirement is not particularly burdensome, we believe that elimination of this requirement would benefit both issuers and the IRS staff.

for rebate on the escrow. NABL recommends further clarification on how this rule applies to variable-rate bond issues.[16]

A better approach would be to simply allow yield reduction payments (as described in Treas. Reg. §1.148-5) to be used to meet the required yield restriction under any and all remedial actions requiring yield restriction. The yield reduction rules contained in Rev. Proc 2018-26 in effect re-invent the wheel. The rules of Treas. Reg. §1.148-5 are robust and clearly indicate how to make such calculations and the amounts and timing of such payments. Use of two different yield reduction payment structures with different calculation details simply creates complexity for no apparent benefit.[17] We note that Treasury and the IRS may have an interest in preventing "yield blending" whereby a defeasance escrow could be invested above bond yield taking advantage of other yield restricted moneys invested below bond yield. If Treasury wishes to prevent such yield blending, it could simply include a sentence in a revised revenue procedure that any defeasance escrow must be yield restricted as though the investments in that escrow were a separate class of investments.[18]

NABL recommends the following changes to the 2018 Redemption/Defeasance Rule:

- Clarify and simplify how the arbitrage rebate payment or yield reduction payment rules apply.
- Unify the approach by applying yield reduction payments determined under Treas. Reg. §1.148-5 to this purpose.

D. Comments on Timing of Nonqualified Use for Failure to Spend Proceeds

Revenue Procedure 2018-26, Section 4.04, defines nonqualified use to include failure to spend proceeds of tax-advantaged bonds within any required expenditure period specified in the applicable Code section, and any use of expended proceeds of tax-advantaged bonds for a purpose other than a qualified use. A nonqualified use occurs under Code §141 on the date of the deliberate action. In contrast, Section 7.03 of Rev. Proc. 2018-26 provides that for proceeds that have been spent, the nonqualified use occurs on the first date on which an action occurs that causes the proceeds to be used for other than a qualified use. For proceeds that have not been spent, the nonqualified use occurs on the earlier of the first date on which the issuer fails to have reasonable expectations to spend the proceeds for a qualified use (in any applicable spending period) or the last day of the required expenditure period, if any (the "failure-to-spend timing rule").

NABL is concerned about practical application of the failure-to-spend timing rule and the difficult judgment calls that will be required under that rule. For example, an issuer may run into

16 This overly complex rule is an appropriate target for Occam's Razor. A complex rule should not be employed when a simpler rule provides all desired outcome.

17 The rule of Rev. Proc 2018-26 also will increase the fees charged by yield computation service providers.

18 NABL is not asserting that such yield blending is in any way abusive, but only that Treasury and the IRS could easily prevent such blending if the IRS or Treasury determined that such blending was inappropriate.

a difficulty (e.g., a significant weather event) that raises concerns about its ability to timely spend the proceeds. In such a case, the issuer may or may not still reasonably expect to timely spend the proceeds. Will the IRS question whether the issuer timely took remedial action because it did not remediate when the significant weather event occurred? Does an issuer fail to have reasonable expectations on any date that it (or a reasonable observer) believes that the issuer is more likely than not to miss a target? Such a definition would create a conundrum in that under that definition nonqualified use begins before there is any nonqualified action and might occur even though the issuer ends up timely spending all proceeds on qualified uses. Under Treas. Reg. §1.141-12, the deliberate action only occurs when the issuer takes a deliberate action that causes private business test limits to be exceeded.

NABL suggests that the Treasury and the IRS modify the failure-to-spend timing rule to reduce or eliminate the subjectivity of the rule. We note that Treas. Reg. §1.142-2 provides a timing rule for when nonqualified use occurs for unspent proceeds; that rule states that the nonqualified use occurs on the earlier of the date on which the issuer reasonably determines that the financed facility will not be completed or the date on which the financed facility is placed in service. NABL believes that this rule provides less subjectivity than the rule in Section 7.03 of the Revenue Procedure. The Treas. Reg. §1.142-2 rule could be modified and incorporated into a revised revenue procedure for use with for tax-credit and direct-pay bonds. As modified, that rule could provide that the nonqualified use occurs for unspent proceeds on the earliest of, 1) the date the applicable spending period, if any, ends, 2) the date on which the issuer reasonably determines that the project will not be completed, and 3) the date on which the financed project is completed.

NABL recommends the following changes to the timing of nonqualified use:

- Revise the rule in Section 7.03 of the revenue procedure for when nonqualified use occurs for unspent proceeds to state that the nonqualified use occurs on the earliest of, 1) the date the applicable spending period, if any, ends, 2) the date on which the issuer reasonably determines that the project will not be completed, and 3) the date on which the financed project is completed.

E. Comments Related to Determining the amount of Nonqualified Bonds

Section 4.05 of Rev. Proc. 2018-26, defines the nonqualified bonds that need to be remediated. Nonqualified bonds are the portion of the then outstanding bonds so that after they are removed, the remaining bonds, if issued on the date on which the nonqualified use occurs, the proceeds of the remaining bonds would be used in a timely manner for a qualified use. Since no tax-credit bonds or direct-pay bonds can be issued after December 31, 2017, this formulation is full of ambiguity. Presumably, qualified use and timing is based on the law in existence when the bonds were in fact issued rather than the date on which the nonqualified use occurs. Even so, the timing aspects are not clear. Suppose that a direct-pay bond (*e.g.* NCREB) was issued July 1, 2017. At the time of the bond issuance the issuer reasonably expected that it would spend 100% of the proceeds of that issue on qualifying costs by July 1, 2020 as required. Suppose further that on July 2, 2019, it no longer reasonably expects to spend 100% by July 1, 2020 but now expects it will need 2 more years (for a total of 4 years) to complete the project. Suppose that the portion of the proceeds that it then expects to spend after July 1, 2020 is 25% of the proceeds. What portion of the bonds outstanding on July 1, 2019 are nonqualified? If bonds were issued on July 1, 2019, the three-year spending period would end on July 1, 2022, by which date, 100% of the proceeds would be expected to be spent. Does this mean that the nonqualified bonds are 0% of the then outstanding bonds?

The problem with the definition of nonqualified bonds is the use of a hypothetical issue of tax-credit or direct-pay bonds on a date later than the actual issue date. What was probably intended is that 25% of the bonds would be nonqualified in the above example. To get to that conclusion however, the expenditure period tested must end on the date it was originally scheduled to end. Note that for Treas. Reg. §1.142-2 and Treas. Reg. §1.141-12, use of a hypothetical bond issue issued when the deliberate action occurs makes sense because the hypothetical bonds could be viewed as refunding bonds, and new expenditure periods do not apply to refunding bonds. That does not work for direct pay and tax credit bonds since they are not allowed to be refunding bonds. Although a proper formulation might take more words, the nonqualified bonds can be properly defined in terms of a hypothetically smaller bond issue issued on the actual issue date.

NABL recommends the following changes to the determination of the amount of nonqualified bonds:

- Revise the rule in Section 4.05 of the revenue procedure to provide that nonqualified bonds means that portion of the outstanding bonds in an amount that, if the remaining bonds (and a pro-rata portion of any bonds that were retired before the nonqualified use of proceeds occurs) had been issued rather than the full amount of the bonds, the proceeds of those remaining bonds (and the pro-rata portion of any bonds retired before the nonqualified use occurs) would be used in a timely manner for a qualified use.

PART II

Comments Concerning Revenue Procedure 2018-26 Extension of Alternative Use of Disposition Proceeds Remedial Action

Prior to the release of Revenue Procedure 2018-26, Treas. Reg. §1.141-12(e) allowed nonqualified use resulting from a sale of financed property exclusively for cash to be remediated through alternative qualified use of the disposition proceeds of that sale. This remedial action was not available to cure other types of nonqualified uses, such as private use resulting from leases, nonqualified management contracts, or other private activity. Revenue Procedure 2018-26 extended the availability of this remedial action to nonqualified use that may result from an eligible longer-term lease of financed property to a private business. We appreciate the extension of this remedial action to certain longer-term leases, but respectfully suggest that the alternative use of disposition proceeds should be more widely available as a remedial action for all types of private use. We believe that issuers should be provided the option to treat any amounts received from (or as a result of) shorter term leases, installment sales or other nonqualified use as disposition proceeds for purposes of Treas. Reg. §1.141-12(e) and to remediate through alternative qualified uses of those proceeds.[19]

In expanding alternate use of disposition proceeds to eligible leases, the rules needed to acknowledge that not all amounts giving rise to disposition proceeds would be received by the issuer (or conduit borrower) at the time of the deliberate action. Accordingly, Rev. Proc. 2018-26 provides that the required actions be taken within a timeframe based on the start of the term of the lease with respect to an amount equal to the present value of all lease payments required to be made under the lease. This treatment may require issuers seeking to utilize the rule to issue taxable debt in order to raise the funds needed to remediate. Such treatment is both expensive for issuers and forces corrective action to be taken before the excessive private use occurs.

A. Comments on Increasing the Scope of Deliberate Actions Eligible for Alternative Use of Disposition Proceeds

While the extension of the Alternative Use of Disposition Proceeds to eligible longer-term leases is helpful, NABL believes that the remedial action may reasonably be extended to a much larger class of contractual arrangements giving rise to excessive private use.

We recognize that not all contractual arrangements giving rise to private use directly provide the bond obligor with payments. We think it appropriate, for purposes of this remedial action, to treat as disposition proceeds all payments received with respect to privately used bond financed property during the period of private use created by such contract plus investment earnings on those amounts. For example, disposition proceeds for a privately managed toll road would include all toll revenues received other than those attributable to ordinary operation and

19 *See* II. B. below for a recommendation concerning the situation when the amount of disposition proceeds that will be received is not determinable on the date of the deliberate action.

maintenance expenses. Using such a broad definition of disposition proceeds would allow any unexpected private use to be remediated through alternate use of disposition proceeds. If this broad approach is not adopted, Treasury and the IRS could nonetheless expand the scope of qualifying contracts beyond cash sales and those certain long-term leases eligible under Rev. Proc. 2018-26.

First, installment sales or similar arrangements should receive similar treatment to eligible leases in the Revenue Procedure. We believe the provisions in Revenue Procedure 2018-26 applicable to eligible leases could be extended to installment sales without changing the intent of the Revenue Procedure.

Second, although extending the alternative use of proceeds remedial action to shorter term leases or other nonqualified uses would be a more substantive change, it would provide needed flexibility to issuers. Shorter-term leases are not inherently more abusive than long-term leases.[20] Indeed, shorter term leases generally create less private use than longer term leases. Currently, eligible leases must be for at least 20 years. We see no reason not to extend such treatment to five-year leases, two-year leases or even one-year leases. Currently eligible leases must have a term that is at least equal to 75% of the useful life of the leased property.[21] We fail to see any policy reasons for requiring eligible leases to extend for a minimum lease term. If Treasury and the IRS wish to limit the availability of this type of remediation to leases and cash sales, all term limitations for leases should be removed.

Currently, bond redemption or establishment of a defeasance escrow for nonqualifying bonds is often the only available remedial action and that can be a substantial burden for issuers. Allowing issuers to use a wide range of "disposition proceeds" for alternative uses would give issuers options while ensuring that the federal subsidy represented by the tax-exempt bonds remained allocable to facilities without excessive private use.

NABL recommends the following changes to the scope of rules for disposition proceeds:

- Revise the rule in Section 5 of the revenue procedure to apply either to all contracts giving rise to private use (in addition to eligible leases) or, if that is too broad a change, to as large a class of such contracts as possible, including shorter term leases, installment sales, and management contracts.

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20 Short term leases of no more than 50 days (or in some cases 100 days or 200 days) generally do not create private use and so would not require remediation. There is however a large category of leases that do create private use but are not eligible for special treatment under Rev. Proc. 2018-26.

21 It is unclear whether this 75% rule is intended to apply to only the leased bond financed property or to all leased property including that financed with equity. Furthermore, it is unclear whether the useful life is the then remaining useful life of the leased property or the original life of the financed property. We note that 75% of the remaining useful life of the property may extend beyond the private use measurement period, which would end on the final maturity date of the bonds.

B. Comments on Determining the Amount of and Timing of Disposition Proceeds.

Revenue Procedure 2018-26 provides that the amount to be treated as disposition proceeds of an eligible lease is equal to the present value of all of the lease payments required to be made under the lease, determined at the start of the lease term (the *"lease amount"*). However, the issuer generally will not receive the lease amount up front and may not have funds equal to the lease amount available to spend on an alternative use within two years, as required by Treas. Reg. §1.141-12(e). We respectfully suggest that an issuer be allowed to treat the lease payments or other amounts received as disposition proceeds as they are received and to treat the receipt of such amounts as the deliberate action solely for purposes of starting the two-year time frame for an alternative use in Treas. Reg. §1.141-12(e)(1)(iii).

Basing the remedial action on the amount actually received would also resolve difficulties in calculation of a "lease amount" as currently required by the Revenue Procedure. Not all lease payments are fixed and determinable as of the start of the lease term. For example, certain leases include revenue-based or expense-based payments in addition to (or in lieu of) fixed payments. While it is helpful and simplifying to use the bond yield as of the start of the lease term for computation of present values of lease payments, for variable yield issues, that applicable bond yield might not be known until the end of the related yield computation period, which could be as long as five years (less one day) from the start of the lease term.[22] Thus, for variable yield issues, the correct present value rate to use might not be known at the time it is required to be applied.

Lease payments (including payments on long term leases) often include operational payments in addition to payments related to the capital costs of the leased facility. For example, a lease may require the lessee pay local real estate taxes or utility payments. The lessor may be required to provide certain services such as cleaning or maintenance, and the lease may provide for payments to cover the costs of those services. Such payments should not be considered disposition proceeds and should not be used in calculating the "lease amount" or the amount required to be used in an alternative use. A revised revenue procedure should clarify that such operational costs are not included in disposition proceeds or the calculation thereof.

Allowing an issuer to apply disposition proceeds as they were received would give issuers great flexibility but would not weaken the nature of the remedial action. The permitted alternative use would occur later than under the current rules but would be in a greater amount (because there would be no need to present value the lease payments). Because lease payments (or other private activity payments) generally track the private use of the financed property, delayed remedial action would not provide issuers with any undue benefit of private use. The Alternative Use of Disposition Proceeds as formulated in Treas. Reg. §1.141-12(e) already requires ongoing

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22 For variable yield bond issues, yield is computed separately for each computation period and while computation periods may be one-year periods, they may also be five-year periods. The choice between one-year and five-year periods must be settled by the end of the first five-year period after the issue date of the bonds.

compliance for up to a 2-year period. Extending that period does not introduce any significant risk of compliance failure.

NABL recommends the following changes to the disposition proceeds rule:

- Revise the rule in Section 5.01(2) to read:

> (2) Treating all amounts received (net of ordinary operation and maintenance costs) with respect to the bond financed property subject to such lease or other contract as disposition proceeds;

- Add a new paragraph to Section 5.01 of the revenue procedure:

> (5) Treating each date of receipt of disposition proceeds as a date of the deliberate action.

- Clarify that operational lease payments are not included in the determination of disposition proceeds.

PART III

Comments Concerning Reducing the Cost of Remediation of Tax Exempt Bonds by Elimination of the Need for Defeasance Escrows.

Treas. Reg. §1.141-12(d) provides that one possible remedial action is to redeem "nonqualified" bonds at the earliest possible redemption date (or if later, within 90 days of the deliberate action.) If the redemption date is more than 90 days after the date of the deliberate action, the issuer must establish a "defeasance escrow" from which the redemption price and all earlier debt service on the nonqualified bonds must be paid. The issuer is required to notify the IRS of the establishment of the defeasance escrow.[23] This is the only remedial action available for many types of deliberate actions involving private use through leasing of bond financed facilities or through management contracts.

Section 7.02 of Rev. Proc. 2018-26 provides that certain unexpected statutory violations may be remediated through redemption of bonds or establishment of a defeasance escrow under rules that are similar to those of Treas. Reg. §1.141-12(d).

Under both defeasance remedial action provisions, the issuer must establish an irrevocable escrow sufficient to pay the principal of and interest on the nonqualified bonds through the required redemption date.

The option to defease nonqualified bonds rather than redeem them within 90 days is very beneficial because it recognizes that not all tax advantaged bonds can be redeemed within a short time period of the deliberate action triggering the need to take remedial action. Tax advantaged bonds (and indeed all bonds) often have call protection provisions.

From the perspective of burdening of the tax-advantaged market or the provision of federal subsidies or the cost to the United States Treasury, the defeasance escrow itself does not help. It is the early redemption of bonds that helps. However, from the cost perspective of the issuer, the establishment of a defeasance escrow is costly. That is because the amount that needs to be invested in United States Treasury obligations is often well in excess of the redemption price of the bonds to be redeemed.[24] The high cost of a defeasance escrow is the result of the very common inability to invest a defeasance escrow at the yield of the defeased bonds based on market conditions. (This is usually referred to as *"negative arbitrage."*) Thus, the current regulations and revenue procedure impose a significant cost on the issuer that does not directly (or even

23 This requirement evidently does not apply under the parallel provisions of Rev. Proc. 2018-26.

24 The regulations and revenue procedure do not require investment in U.S. Treasury obligations, but local law and prudence generally require low yielding high quality investments and as a practical matter most defeasance escrows are invested in U.S. Treasury obligations or in certain U.S. agency obligations, or in obligations effectively guaranteed by the United States.

indirectly) benefit the United States or relieve any burdening on the tax-exempt (or tax-advantaged) market.[25]

The establishment of a defeasance escrow does make the bond redemption automatic and removes the possibility of failure of an issuer to follow through on a promise to redeem bonds, but there are cheaper ways of removing those risks.

The only reason to require a defeasance escrow is to assure that the local government not renege on its obligation to redeem bonds. If the bond issuer were required to notify the IRS of redemption plan (such as is the current situation with respect to defeasance escrows under Treas. Reg. §1.141-12(d)), the IRS would have a simple and effective way to enforce the issuer covenant to redeem bonds. It could declare the bonds taxable (or not tax advantaged) if they are not redeemed on the required date.[26] To further simplify enforcement, the state or local government could be required to notify the IRS of the actual redemption. A bond issue could be classified for examination if the second notice was not received at the time specified in the first notice.

Additionally, the establishment of an escrow, as required under current law, generally entails the retention of a financial institution as escrow agent to cause the redemption of the nonqualified bonds without further direction or involvement of the issuer. For example, the escrow agreement often mandates that the escrow agent bank send out the notice of redemption to bondholders without further direction by the issuer. The benefits of such third-party involvement could be mandated even without the establishment of a defeasance portfolio. (Although, it is not mandated under current law even with the establishment of a defeasance escrow.) To further this end, a remedial action involving a future redemption could require such a third party fiscal agent.[27] The remedial action required within 90 days of the deliberate action could include a contract with such a fiscal agent under which the fiscal agent would be required to send out a notice of redemption without further direction of the bond issuer.[28]

In most cases, the period from the deliberate action creating the private use until the redemption date is relatively short. If Treasury and the IRS view the establishment of a defeasance portfolio of investments to be important to assure future compliance over a long period, where perhaps the availability of the funds necessary to effect the redemption is less certain, the regulations could continue to require the establishment of an escrow when the period involved is

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25 Bond owners receive a windfall from such defeasance because the credit quality of their bonds improves significantly as a result of the defeasance, but such windfall to bond owners in no way furthers the purpose of the remedial action.

26 For tax credit and direct pay bonds, the IRS could simply not make any tax credit payments on such bonds beyond the date of the required redemption.

27 There is of course a cost to hiring such a fiscal agent, but that administrative cost would be no more than the cost of hiring an escrow agent and is small compared to the cost of negative arbitrage.

28 For publically held bonds, the bond issuer may also need to post its irrevocable call of the nonqualified bonds on EMMA, further limiting the issuer's ability to renege on its promise to call such bonds.

relatively long, say seven years or more but not require such a defeasance escrow for shorter redemption periods.

The added cost of establishment of a defeasance escrow, especially for periods of less than seven years, creates a disincentive to effective use of lease and management contracts without providing any benefit to the United States. Escrows covering seven or fewer years may be invested well below the yield on the Bonds because the required Treasury obligations will be short and low yielding.

NABL recommends the following to allow for remediation through redemption without defeasance:

- A supplemental Revenue Procedure should provide that in any case otherwise allowing remediation through the establishment of a defeasance escrow for the redemption of nonqualified bonds on the first possible call date, the issuer may remediate as described below:[29] Such revenue procedure would provide a method for issuers to remediate compliance issues by assuring the timely redemption of nonqualified bonds without the need to create and pay for a defeasance escrow. An issuer using this remedial action would be required to redeem the nonqualified bonds on the first possible redemption date of the nonqualified bonds. In general, the required conditions for taking the action would be the same as are currently required under Treas. Reg. §1.141-12(d) or Section 7.02 of Rev. Proc. 2018-26, except that no escrowed investments would be required and as shown below.

<u>A. IRS Notification:</u>

The issuer would need to provide the IRS the same type of notice now required for the establishment of a defeasance Escrow for the establishment of a plan to redeem bonds.[30] The notice could require the issuer to provide the amount, redemption date and CUSIP of the bonds to be redeemed. Additional notice could be required to verify to the IRS that the redemption had taken place.[31] The failure of the issuer to provide such confirmation would alert the

29 Such revenue procedure would be issued under the authority of Treas. Reg. §1.141-12(h).

30 We are not convinced that such notification requirement is sufficiently beneficial to outweigh the burdens associated. If notification continues to be an element of remediation trough redemption, we strongly suggest that such notification be by specially designed form filed with a Service Center so that the IRS can actually access the information easily. As with any information to be collected, the IRS and Treasury should carefully evaluate what it will use the information for. The one use that we have identified for such notification is to provide the IRS with a direct path to any bond issue that began the remediation process but did not follow through.

31 We would recommend that such notification be provided on a new 8038 series form. That would allow the IRS simpler procedures for managing the information provided. See the 2012 ACT report concerning proposed Form 8038-N.

IRS to a failure to redeem bonds and such a failure to redeem bonds would nullify any remedial action dependent on such redemption.

B. Fiscal Agent:

Such revenue procedure could require that the issuer employ a third party fiscal agent to send out the redemption notices to ensure timely redemption. The issuer would be required to irrevocably call such nonqualified bonds for redemption on the proper date. While unlike a defeasance escrow there would be no requirement to fund the redemption price (or any of the interim interest payments), the issuer would be giving up any discretion concerning the redemption of these bonds on the first possible redemption date.

C. Limitation on Time to Redemption:

As the period between the deliberate action and the earliest possible redemption date grows, the yield on escrowed securities may increase and negative arbitrage associated with an escrow requirement may become less costly. While we believe that no timing limitation (other than the 10.5-year redemption requirement currently required by Treas. Reg. §1.141-12(d)) is necessary, the rules could limit the duration of a permitted future unfunded redemption covenant. For example, the use of this alternative could be limited to cases where the nonqualified bonds could be redeemed within seven years of the deliberate action.

PART IV

Comments Concerning Private Payment Remediation.

Under Section 141 of the Code, generally bonds are private activity bonds only if both private use of bond-financed facilities exceeds certain limits, and also payments (or security) with respect to such privately used facilities exceeds proscribed limits.[32] For both the private business use test and the private payment (or security) test, the issuer must not expect to violate the test and must not take a deliberate action to violate the test.

Under current law, remediation is available to cure private use or private loans but is not available to cure excessive private payments.[33] An issuer confronted with unexpected payments with respect to privately used bond financed property can only remediate the private use and not directly the excessive private payments.[34] Some bond issues are structured to acknowledge private use of bond-financed facilities, but to limit the payments that can be derived from such use.[35] Such bonds are usually supported by taxes of general applicability.

The following example is useful in understanding the need for an expanded remediation rule and is also useful in understanding the NABL proposals appearing below.

An issuer could issue $50,000,000 of tax-supported bonds to construct a civic convention center that includes portions that can be leased out for various purposes. The issuer may want to utilize a private manager (with a nonqualifying management contract) for such facility so that the entire facility will be privately used. While lease revenues from the center could possibly arise, a feasibility study obtained before the bonds are issued may show that revenues from the convention center are unlikely to even cover the ordinary operation and maintenance costs of running the center. Nevertheless, the issuer may determine that the convention center is in the public interest because the center will attract businesses and increase employment in the area. It may also provide for increased civic pride. The feasibility study may (but does not need to) show that increased tax collections as a result of the convention center may be sufficient to pay the debt service on the bonds. The issuer does not pledge the convention center or the revenues derived from it to the payment of the bonds.

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32 Bonds are also private activity bonds if a sufficient portion of the proceeds is used to make or finance loans to a private entity. Bonds can also be private activity bonds as a result of the use of bond proceeds to acquire non-governmental output property. Private loan bonds and bonds financing non-governmental output property are private activity bonds even if private payments are properly limited.

33 The limit on private payment is generally 10% of debt service, but if the payments are with respect to privately used property that is unrelated to or disproportionate to the governmental use of the bond-financed property, the limit is 5%. For qualified 501(c)(3) bonds the limit is 5%.

34 Since payments are treated as private payments only if there is private use, the issuer could remediate private use and thereby eliminate private payments. However, such remediation often is out of proportion to the amount by which the private business use tests are met.

35 Such bond issues also avoid any private loans and avoid private security.

Although unexpected at closing, changed circumstances may, after the issuance of the bonds, make it possible for the issuer to receive revenues from the center in excess of 10% of the debt service on the bonds.[36]

Under current law, an issuer may choose not to accept payments that would put it over the limit on private payments or to increase its ordinary reasonable operation and maintenance expense, but otherwise has little ability to manage private payments. At times, opportunities do present themselves in ways that prudent managers of local governmental entities would like to take advantage of. We believe that such unexpected private payments should be eligible for remediation in one of two ways:

1. The issuer receiving excessive private payments could make a direct payment to the United States Treasury of the amount exceeding the limit on private payments applicable to the bond issue. This amount, referred to herein as a "Private Payment Reduction Payment" would be paid directly to the United States Treasury in a manner similar to the payment of excess arbitrage profits. Indeed, our recommendation would be for the I.R.S. to use Form 8038-T for such payments. We believe that such use of the form could be made without modification to the form itself, but with modification of the instructions for Form 8038-T.[37]

We note that this type of remediation through direct payment to the United States is specifically authorized under Treas. Reg. §1.141-12(h).

2. The issuer receiving such excessive private payments could treat such amounts as "disposition proceeds" and use such amounts in an alternative way that is allowed for proceeds of tax-exempt bonds. Remediation under this proposal would be more beneficial to issuers than the direct payment described above and would also reduce the burden on the tax advantaged bond market by reducing tax advantaged borrowing. If an issuer made such alternative use of disposition proceeds that were generated as payments with respect to privately used property, then payments with respect to the property financed with such disposition proceeds should be treated as private payments because they are indirectly derived from the private payments treated as disposition proceeds.

In the example used to illustrate private payment remediation, the issuer could take the revenues derived from the convention center in excess of the permitted amounts (5% of debt service in the example) and spend such amounts on capital improvements to a public park that does not produce any revenues.[38]

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36 The limit might be 5%, but 10% is used in this example for illustrative purposes.

37 Line 17 of Form 8038-T is for "penalty in lieu of rebate." This is a highly underutilized line at present and using this line for other payments related to the private business tests is both appropriate and non-confusing. If Line 16 is left blank, that will indicate that this is not related to the 2-year rebate exception.

38 If the issuer were to receive revenues from the park, those revenues would need to be treated as derived from the privately used convention center.

While this option might in some circumstances provide little benefit to issuers, in other circumstances, the disposition proceeds would be used to finance non-revenue producing property and thus would be beneficial. The use of such "disposition proceeds" to finance other facilities that could have been financed with tax-exempt bonds directly reduces the burden on the tax advantaged bond market.

NABL recommends the following changes to permit private payment remediation:

- Private Payment Remediation to be allowed in one of two ways
    - Private Payment Reduction Payable Paid to US Treasury with Form 8038-T.
    - Private Payments would not count if the issuer used the Private Payments to acquire or construct suitable property, but payments with respect to such property would be considered Private Payments.

PART V

Comments Concerning Taxpayer Exposure Remediation.

At times, an issuer may determine that an unexpected deliberate action results in certain nonqualified bonds. Current rules of both Treas. Reg. §1.141-12 and Rev. Proc. 2018-26 provide guidance on determination of the amount of nonqualified bonds.[39] Once nonqualified bonds are identified current rules provide ways to terminate the tax subsidy with respect to such bonds by redemption or defeasance of those bonds or in the case of direct pay bonds by reducing the tax credits claimed by the issuer. An alternative approach might be to allow the issuer to pay to the United States Treasury the amount that the tax advantage of such nonqualified bonds costs the United States, or an approximation thereof. This could be very useful in cases where bonds could not be redeemed (*e.g.* they don't satisfy the 10 ½ year call rule) or where even though they could be redeemed, such redemption would be more expensive than taxpayer exposure (*e.g.* where the rate payable on the tax advantaged bonds is below the then current rate for bonds with no tax advantage). In such a case, the payment of an amount commonly called "taxpayer exposure" should be sufficient remediation. We believe that to be most effective, such taxpayer exposure calculation should be based on easily determinable inputs including a tax rate that is provided by the relevant Revenue Procedure. We note that a recent memorandum from the director of TEB/ITG provided reasonable directions for computation of taxpayer exposure, the substance of which could be easily incorporated into a revenue procedure.[40] An important feature of the calculation of taxpayer exposure is that the computation is mechanical and generally does not require evaluation of the tax position of the owners of the bonds. It is perhaps a "rough justice" approach that may in particular cases penalize issuers more or less than theoretically appropriate.

We believe that remediation involving a payment of taxpayer exposure is specifically authorized under Treas. Reg. §1.141-12(h). Furthermore, it can be implemented by utilizing payments with existing Form 8038-T.[41]

NABL recommends the following changes to allow taxpayer exposure payment for remediation:

- Payments of taxpayer exposure on nonqualified bonds be allowed as a remediation.

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39 But in some cases, the guidance of Rev. Proc. 2018-26 might benefit from clarification. See our comments on Parts I and II.

40 Memorandum from Christie Jacobs, Director of Tax-Exempt Bonds/Indian Tribal Governments dated July 16, 2018 (Control Number TE/GE-04-0718-0017). The Memorandum expires on July 16, 2020. The Memorandum may be found at https://www.irs.gov/downloads/foia/ig/spder.

41 Line 19 of Form 8038-T is for termination of the "penalty in lieu of rebate." This is a highly underutilized line at present and using this line for other payments including remediation through payment of taxpayer exposure is both appropriate and non-confusing. If Line 16 is left blank, that will indicate that this is not related to the 2-year rebate exception.

PART VI

Comments Concerning Clarification and Expansion of Anticipatory Remediation.

A. Clarify Existing Anticipatory Remediation Guidance.

On October 27, 2015, Treasury adopted Final Regulations under Treas. Reg. §1.141-12(d)(3) to permit an issuer to redeem or defease bonds in advance of a deliberate action that would cause the private business tests to be met. These Regulations encourage the retirement of tax-exempt bonds before the occurrence of nonqualified use and generally further the policy of redeeming tax-exempt bonds earlier rather than later.

To address the concern of issuers potentially treating ordinary bond amortization payments as "anticipatory remedial actions," Treas. Reg. §1.141-12(d)(3) requires an issuer to declare its intent to redeem or defease bonds in advance of a deliberate action in a manner similar to the declaration of intent for reimbursement contained in Treas. Reg. §1.150-2(e).[42] Section 1.141-12(d)(3) requires the issuer to "describe the deliberate action that potentially may result in the private business tests being met." Further guidance concerning this description requirement would significantly enhance the usefulness of anticipatory remedial action.

With regard to official intent for reimbursement, the Treas. Reg. §1.150-2(e) provides that a general description is sufficient to describe the project for which the issuer is seeking reimbursement (e.g. highway capital improvement program, hospital equipment acquisition, etc.). With regard to anticipatory remedial actions, NABL seeks clarification that it would be permissible to describe a future deliberate action with similar generalization.

Particular concern relates to deliberate actions that are not expected on their own to cause the private business tests to be met.

The following example illustrates this comment:

> City A sells to a private developer a parcel of unused bond-financed land, the acquisition of which was part of a larger bond-financed project. Prior to the sale of the land, City A calculated a total of 3% cumulative private business use in the Project from the lease of a portion of its City Hall to a small café on the ground floor. City A calculates that the sale of the land will generate an additional 6% private business use on the Bonds. City A adopts an Official Intent Resolution outlining the private business use from the café lease and land sale and a general description of private business use that may arise in the future with respect to the Project. City A then redeems the nonqualified bonds associated with the land sale with proceeds from the sale.

42 The intent of this requirement is to require the issuer to memorialize the purpose of the bond redemption or defeasance. The official declaration of intent to defease or redeem bonds is a little odd in that the redemption or defeasance will generally be undertaken at the same time as (or very shortly after) the declaration. The regulations do not require the issuer to declare its intention to meet the private business tests.

In the example above, City A only reached a total of 9% private business use from the sale of the land. A requirement that the declaration of intent describe with detail the last deliberate action that might result in the private business tests being met, would result in the City being unable to take an anticipatory remedial action with respect to the sale. At the time of the land sale, the City does not know the nature of future use that may provide the additional 1% use to cause the Bonds to meet the private business use test. However, it is at that time that the City is best positioned to remediate the private use with proceeds of the sale. If the City were instead to invest the land sale proceeds until an additional amount of private business use causes the private business tests to be met, the result is detrimental to both the City (from the negative arbitrage cost of retaining the land sale proceeds) and Treasury (since the nonqualified Bonds remain outstanding until the 10% threshold is reached). Allowing a general description in the intent resolution better serves the stated policy of the Final Regulations of encouraging redemption of tax-exempt bonds earlier rather than later. Issuers would appreciate guidance that clarified that the described deliberate action need not be the last deliberate action causing the private business use test (or private loan financing test) to be met, but could be any deliberate action that cumulatively might cause the private business use test to be met.

While there may be concern that issuers would treat ordinary bond amortization payments as "anticipatory remedial actions" for small amounts of existing private business use and create additional qualified equity in projects, NABL believes this concern is eliminated with the requirement that the issuer declare its intent within 90 days of the deliberate action. However, if the concern persists, it could be further addressed with a requirement that an issuer represent in its declaration of intent that, but for the deliberate action, it would not expect to take the remedial action.

NABL recommends the following changes to facilitate anticipatory remediation:

- Treasury should clarify the detail required in Declaration of Intent and specifically indicate that the described deliberate action need not be the final deliberate action causing private business tests to be met.

B. Expand Anticipatory Remediation Guidance.

Our comments in Part I include a recommendation that anticipatory remediation be expanded to include remediation applicable to direct pay bonds under Rev. Proc. 2018-26. We make a broader recommendation that every remedial action that is permitted within 90 days of an action that creates the need to remediate should also be permitted prior to the time of the violation so long as the issuer adequately declares the remedial action as relating to the potential violation.[43] For example, in certain circumstances, an issuer of governmental bonds may sell or lease bond financed facilities to a qualified 501(c)(3) organization. If it does so, the issuer may remediate by taking various actions required for 501(c)(3) bonds and treating the bonds as reissued for specific

43 This would include alternate use of disposition proceeds that is required to be deposited into a project fund within 90 days but can be spent on the project up to 2 years after the deliberate action.

purposes. We recommend that an issuer be able to take such an action, including holding a public hearing and filing a new Form 8038 at any time in anticipation of such a sale or lease.

At present, only bond redemption or defeasance is eligible for anticipatory remediation. There is no reason that issuers should not be able to take any remedial action in anticipation of a potential violation. In the case of alternate use of disposition proceeds, such an anticipatory use would require estimating or determining the amount of disposition proceeds. If the actual amount of disposition proceeds determined at a later disposition turned out to be more than the amount used, then the issuer could be required to complete the remedial action by using the additional funds up to the actual disposition proceeds for such alternative use.

Any remediation otherwise permitted within 90 days of a deliberate action, including per our other proposals, a payment of taxpayer exposure, a payment of a private payment reduction payment, alternate use of disposition proceeds or other revenues derived from the private use of a bond financed facility, use of all disposition proceeds to redeem or defease a portion of the nonqualified bonds, or alternate use of a facility should be allowed on an anticipatory basis. Treasury should clarify that such anticipatory remediation could be used even if the deliberate action being remediated was not expected to cause limits on private use to be exceeded, even if the timing of any future violation of the private activity rules was unknown at the time of the remediation, and even if the violation was not expected, so long as the violation was thought plausible.

Under the current provisions of Treas. Reg. §1.141-12(d)(3) anticipatory remediation can be used in two situations, where the remedial action is the redemption or defeasance of all of the nonqualified bonds (Treas. Reg. §1.141-12(d)(1)) or where the deliberate action is a sale exclusively for cash and the disposition proceeds would have been used to redeem or defease a portion of the nonqualified bonds using all of the disposition proceeds from the sale (Treas. Reg. §1.141-12(d)(2)). However, the wording of Treas. Reg. §1.141-12(d)(3) makes it difficult to use in the case that the amount of disposition proceeds is insufficient to redeem all of the nonqualified bonds. The requirement of Treas. Reg. §1.141-12(d)(3) is that "all of the bonds that would become nonqualified bonds" be redeemed or defeased, even though under Treas. Reg. §1.141-12(d)(2), only "a pro-rata portion of the nonqualified bonds are redeemed.

The ambiguity of the current rules can be demonstrated with the following simple example. Suppose that 100% of the proceeds of a $10,000,000 bond issue is used to finance a single facility. Suppose that the facility declines in value for various reasons so that the fair market value of the facility is only $5,000,000 and that the issuer reasonably expects to sell the facility exclusively for $5,000,000 of cash. Suppose that all $10,000,000 of Bonds remain outstanding and that such bonds are currently callable. If the issuer waits until the sale of the facility, it will be able to remediate by calling $5,000,000 of bonds, but it would seem that even though the anticipatory remediation provision is intended to apply to this situation, the issuer to apply it would need to redeem all $10,000,000 of outstanding bonds if it wished to remediate before the sale. The current rules therefore discourage issuers from redeeming tax-exempt bonds at an early date in favor of keeping them outstanding until the cash sale has been executed.

NABL recommends the following changes to expand the scope of anticipatory remediation:

- A more general anticipatory remedial action rule could read as follows:

  - *Anticipatory Remedial Action.* – The requirements of any of the rules resulting in a remedial action shall be deemed to be met if the issuer declares its official intent to take actions required by such rule in the event of a subsequent deliberate action that would cause the private business tests to be met and takes such actions prior to the date otherwise required for such remedial actions. Such actions could include redemption of bonds, making a payment to the United States of America, or making a capital expenditure for a facility. The issuer must declare its intent on or before the date on which it takes such action (or within 60 days thereafter) and the declaration of intent must identify the financed property or loan or unspent proceeds with respect to which the anticipatory remedial action is being taken and describe the deliberate action that potentially may result in the private business tests being met or other violation occurring (for example the sale of the financed property that the buyer may then lease to a nongovernmental person). Rules Similar to those in Treas. Reg. §1.150-2(e) (regarding official intent for reimbursement bonds) apply to declarations of intent apply for purposes of this declaration, including deviations in the descriptions of the project or loan and the deliberate action and the reasonableness of the official intent. A declaration of intent need not identify with specificity the subsequent deliberate action which may result in the private business tests being met as long as the issuer identifies the current deliberate action and the issuer represents that, but for the deliberate action, the remedial action would not have been taken.

PART VII

Comments Concerning Additional Remedial Actions for Public Purpose Infrastructure Projects.

The additional remedial action provided for eligible leases in Section 5 of Rev. Proc. 2018-26 closely follows the recommendations set forth in the "Legislative Outline for Rebuilding Infrastructure in America" released by the White House in February 2018 (the "Legislative Outline"). The Section of the Legislative Outline captioned "Infrastructure Financing Programs" proposes an additional remedial action that "would allow the recycling of an amount equal to the total present value of a private lease of any project financed with governmental bonds into expenditures for governmental use within two years of the lease." The Legislative Proposal also proposes an addition remedial action that "would allow alternative business use of the public project in an [sic] manner that would qualify" under standards for proposed new types of infrastructure qualified private activity bonds.

The Legislative Outline makes the case that it is appropriate, as a policy matter, to extend tax benefits to public infrastructure projects that have public attributes that ensure the public nature of eligible infrastructure, even if those public infrastructure projects are treated as used for private business use. The required public attributes are as follows:

1. Either State or local governmental ownership or private ownership under arrangements in which rates charged for services or use of projects are subject to State or local governmental regulatory or contractual control or approval; and
2. Availability of projects for general public use (*e.g.*, public roads) or provision of services to the general public (*e.g.*, water service).

For purposes of the governmental ownership alternative under this public attributes requirement, the Legislative Outline proposes a new safe harbor that would treat a project as governmentally owned for this purpose when a State or local governmental unit leases the project to a private business provided that –

1. The term of the private lease is no longer than 95% of the reasonably expected economic life of the project;
2. The private lessee irrevocably agrees not to take depreciation or investment tax credit with respect to the project; and
3. The private lessee has no option to purchase the project other than at fair market value.

NABL notes that both the proposal for the remedial action permitting recycling lease payments (implemented by Rev. Proc. 2018-26) and the proposal for an additional remedial action for public infrastructure set forth in the Legislative Outline are framed as legislative proposals. Accordingly, through Rev. Proc. 2018-26, the Treasury has expressly acknowledged that it is appropriate to implement legislative proposals relating to tax-exempt bond remedial actions set forth in the Legislative Outline through administrative action. Also, the Treasury has acknowledged that it has broad regulatory authority to provide for flexible remedial actions to interpret the "are to be used" requirement of Section 141(b) of the Code in a manner that furthers public purposes.

NABL recommends the following changes concerning remediation of public infrastructure property:

- Treasury implement through a revenue procedure or similar pronouncement the additional remedial action for public infrastructure projects set forth in the Legislative Outline by regulatory action. Specifically, such revenue procedure adopted pursuant to the authority of Treas. Reg. §1.141-12(h) should provide that an unexpected (at closing) deliberate action resulting in private use of a bond financed facility in excess of permitted limits may be remediated through an assurance that the facility would

  1. Be owned either by a State or local government or by a private person under arrangements in which rates charged for services or use of projects are subject to State or local governmental regulatory or contractual control or approval; and

  2. After the unexpected change, the financed project remains available for general public use (*e.g.*, public roads) or for the provision of services to the general public (*e.g.*, water service)

- For purposes of the governmental ownership requirement, the new revenue procedure would include a new safe harbor that would treat a project as governmentally owned for this purpose when a State or local governmental unit leases the project to a private business provided that –

  3. The term of the private lease is no longer than 95% of the reasonably expected economic life of the project;

  4. The private lessee irrevocably agrees not to take depreciation or investment tax credit with respect to the project; and

  5. The private lessee has no option to purchase the project other than at fair market value.

APPENDIX A
NABL AD HOC TASKFORCE MEMBERS

David Cholst, Chair
Chapman and Cutler LLP
111 West Monroe Street
Chicago, Illinois 60003-4080
Telephone: (312) 845-3862
Email: Cholst@chapman.com

Michael G. Bailey
Foley & Larder LLP
321 N Clark St., Suite 2800
Chicago, Illinois 60654-4504
Telephone: (312) 832-4504
Email: mbailey@foley.com

William A. Milford
Bryant Miller Olive
111 Riverside Avenue, Suite 200
Jacksonville, FL 32202
Telephone: (904) 384-1264
Email: wmilford@bmolaw.com

Rebecca Harrigal
Greenberg Traurig
2700 Two Commerce Square
2001 Market Street
Philadelphia, PA 19103
Telephone: 215-988-7836
Email: harrigalr@gtlaw.com

Alison J. Benge
Pacifica Law Group LLP
1191 Second Avenue, Suite 2000
Seattle, Washington 98101
Telephone: 206-602-1210
Email: alison.benge@pacificalawgroup.com