REPORT #528

New York State Bar Association

TAX SECTION

Letter on Investments in Tax-Exempt

May 21, 1986

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May 21, 1986

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Roger:

A technical modification in the tax-exempt bond arbitrage rebate provisions would greatly simplify compliance by many issuers. This technical modification would make clear that an investment in shares of a tax-exempt money market mutual fund qualifies as an investment in a “tax-exempt obligation.”

Because investments in tax-exempt obligations do not create a potential for an arbitrage profit resulting from differentials between taxable and tax-exempt yields, the arbitrage rebate requirement does not apply to such investments. If it were made clear that investments in shares of tax-exempt money market mutual funds also do not give rise to rebatable arbitrage profits, issuers would be given a simple investment option, providing protection of principal, demand withdrawal privileges and eliminating burdensome accounting requirements.

Such a modification would also ease the pressure on the Treasury Department's Bureau of Public Debt by reducing the volume of requests for issuance of special yield-restricted Treasury securities.

Section 147 of the House version of H.R. 3838, the Tax Reform Act of 1985 (the “Bill”), would extend to all tax-exempt bonds the arbitrage rebate requirement currently applicable to most industrial development bonds. Under the Bill, as under present law, the arbitrage rebate requirement would not apply to the investment of proceeds in another “obligation” exempt from tax.

The use of the term “obligation” in this context has caused a technical problem under current law, involving the investment of proceeds in tax-exempt mutual funds. This problem would be continued under the Bill. Specifically, the reference to an “obligation” appears not to include the investment in shares of a mutual fund that can pay exempt-interest dividends under Section 52(b)(5) of the Code. For purposes of the exception from the arbitrage restrictions, there should not be a technical distinction between an “obligation” and such a mutual fund share. Thus the exception from the definition of “investment property” in Section 147(b)(2) of the Bill should include a mutual fund share that pays exempt-interest dividends as well as any tax-exempt obligation.

Under Section 852(b)(5), only 50% or more of the total assets of a regulated investment company issuing such a security must consist of obligations described in Section 103(a) of the Code. Solely for purposes of an expanded exception to the arbitrage restrictions, it may be appropriate to apply a higher percentage standard (e.g., 95 %), so that substantially all of the assets of such a company would be obligations described in Section 103(a) of the Code.

Because Section 852(b)(5) requires that the company paying exempt-interest dividends be a “regulated investment company,” as defined in Section 851 of the Code, the securities of such a company that might be sold to a tax-exempt issuer should be available to it on the same terms (including yield) as those offered to the general public. However, it may be appropriate to specify that a qualified fund could issue only one class of shares to ensure that a so-called “dual purpose fund” (which can issue two classes of shares) would not be eligible.

We would be pleased to discuss the foregoing with you a t your convenience.

Sincerely,

Richard G. Cohen
Chairman