November 26, 1999

Commissioner Charles Rossotti
Internal Revenue Service
1111 Constitution Ave., NW.,
Washington, DC 20044

Re: Arbitrage Restrictions Applicable to Tax-exempt Bonds Issued by State and Local Governments 64 Fed. Reg 166, 46876; CC:DOM:CORP:R REG-105564-99

Dear Commissioner Rossotti:

The Office of the Chief Counsel for Advocacy of the U.S. Small Business Administration was created in 1976 to represent the views and interests of small business in federal policy making activities.[1] The Chief counsel participates in rulemakings when he deems it necessary to ensure proper representation of small business interests. The Chief Counsel also reports to Congress annually on federal agency compliance with the Regulatory Flexibility Act (RFA)[2] and works with federal agencies to ensure that their rulemakings demonstrate an analysis of the impact that their decisions will have on small businesses.

On August 27, the IRS published a notice of proposed rulemaking that sets out certain arbitrage restrictions applicable to tax-exempt bonds issued by State and local governments. The preamble states that the "proposed amendments affect issuers of tax-exempt bonds". One way it affects them is by limiting the amount of fees for the placement of bond proceeds that the issuers can declare under the safe harbor provisions as "qualified administrative expenses" for the bond issue. Though the preamble does not mention them, it is apparent that this regulation will have a significant impact on the bidding agents who earn fees finding competitive investment service providers to offer guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow. The investment service providers must be carefully selected by the bidding agent to match the legal and investing standards applicable to the bond issuer.

The IRS lists as one basis for promulgating this rule that "practitioners" have a problem because there is uncertainty about what can reasonably be allowed as an administrative expense. Also, the calculation for the reasonableness test under §1.148-5(e)(2)(iii) is pronounced too complex. Understandably, bond counselors who provide legal advice to bond issuers would like a bright line on which to rest their opinions. In the name of simplicity, one safe harbor fee calculation is proposed which the IRS selected to "fairly

[1] Pub. L. No. 94-305 (codified at 15 U.S.C. §§ 634a-g, 637)_
[2] Regulatory Flexibility Act, 5 U.S.C. § 601, as amended by the Small Business Regulatory Enforcement Fairness Act, Pub. L. No. 104-121, 110 Stat 866 (1996)

compensate most brokers".[3] It is the basis and the establishment of this safe harbor that will have the most impact on small businesses.

The IRS has provided virtually nothing in the record to support this rule. Did the IRS receive a thousand complaints from "practitioners"? Were hearings or studies or inquiries done to make a record? Were bidding agents or even bond issuers consulted as to the reasonableness of the fees and the basis for the fees? Were there other problems, such as rate burning, that were also the basis for this rule? Have alternatives been investigated? It would seem that these would be important points to investigate and understand before an agency "sets a price" by regulation for what had been a competitively offered service.

The phrase "sets a price" is appropriate to describe what this regulation would do to bidding agents. In the heavily regulated and carefully analyzed world of bond offerings, a "safe-harbor" offered to a bond counsel becomes the standard for the marketplace. The comments filed in this proceeding will show that the proposed safe-harbor ceiling (set at $25,000) will not even cover the cost of professional liability insurance on large bond offerings. The record will also show that bidding agents have a history of providing value for their services and that the value increases proportionately with the value of the bond offering. If the agency has another basis for promulgating this rule, then it should disclose it and the supporting evidence so that the basis can be fully commented upon. Without such disclosure, the comments can not fairly address all the bases of the proposal.

APPLICABILITY OF THE REGULATORY FLEXIBILITY ACT

The IRS performed no initial regulatory flexibility analysis (IRFA) and provides no certification that this rule will not have a significant impact on a substantial number of small businesses. The 'Special Analyses' section of the proposed rule states as follows:

> "It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S. C. chapter 6) does not apply."

The Office of Advocacy disagrees with the Service's determination that the proposed rule is "interpretative" and therefore not subject to notice and comment as required by the Administrative Procedures Act (APA). An initial regulatory flexibility analysis should have been done and would have been very helpful.

Legislative Rule vs. Interpretative Rule

[3] This statement is listed in the preamble at page 46877 referring to the standard in the new reg: §1.148-5(e)(2)(iii)(B)(ii) "the lesser of $25,000 and .2%of the computational base,"…

A "rule" that is subject to the RFA is any rule "for which the agency publishes a general notice of proposed rulemaking pursuant to section 553(b) of the APA or any other law." [4] Section 553(b) of the APA provides, "…Except when notice or hearing is required by statute, this subsection does not apply- (A) to interpretative rules..." The Service has steadfastly maintained over the years that the vast majority of its rules are interpretative rules and therefore not subject to the APA or the RFA.

The distinction between legislative and interpretative is important in this case because it is necessary for the Service to first make a decision that a proposed rule is interpretative before it can claim exemption from complying with the RFA based on its assertion that there is no information collection requirement imposed on small entities.

Generally, a determination whether a rule is "legislative" and, therefore, subject in all cases to the RFA, or "interpretative" and, therefore, not subject to the RFA (unless there is an information collection requirement), has rested on whether the rule is the "product of an exercise of delegated legislative power to make law through rules (and therefore a legislative rule),[5] the degree of discretion left to the IRS to fashion a rule and the scope of the rule that was fashioned. [6]

In this case, the rulemaking qualifies as legislative and would have benefited from a full analysis for two reasons. First, the safe harbor set by the new rule §1.148-5(e)(iii)(B)(ii) means more in this industry than the normal safe harbor. It takes on the character of a new ceiling set by the agency above and beyond the statute. As such, there is a serious and significant impact on the bidding agents. Their costs will exceed their fees on large bond issues if bond counsel clings to the safe harbor as the only sure method of establishing "reasonableness" for IRS tax exempt purposes. This is in effect a legislative rulemaking and that deserves thorough analysis of its impact.

Second, the RFA provides that the initial regulatory flexibility analysis should contain "a description of any significant alternatives to the proposed rule which accomplish the state objectives of applicable statures and which minimize any significant economic impact of the proposed rule on small entities"[7]. It would have been a tremendous help to the industry as a whole to have a field of alternatives to review and comment upon. As it is, the IRS

---

[4] 5 U.S.C. §601 2(b)

[5] *Administrative Law Treatise,* Kenneth Culp Davis, KC Davis Publishing, 1979, p. 36.

[6] See Testimony of Commissioner Roscoe Egger, Internal Revenue Service , Implementation of the Regulatory Flexibility Act: Hearings before the Subcom. On Special Small Business Problems of the House Committee on Small Business, 99th Cong., 2nd Sess.(1986) p. 70 The difference between legislative and interpretative is: "primarily the degree of discretion that we have in applying the rules. In other words, if the statute is not specific but says 'this is the objective we want to achieve and you (IRS) write the rules to achieve it' we regard those as legislative; but when they say 'these are the rules,' obviously then they are interpretative."

[7] 5 U.S.C. 603(c)

will have some scattered suggestions, but they will be reviewed in a vacuum, without helpful public discourse from the experts in the field.

SUMMARY

This is the kind of rulemaking where the application of the Regulatory Flexibility Act and the Small Business Regulatory Enforcement Fairness Act could be a tremendous help to an agency in providing reasonable and thoroughly considered rules.

The IRS should consider doing a thorough analysis of the impact of this rule and republishing the proposed rule and the initial regulatory flexibility analysis for comment. If there are other bases that justify this change, they should be spelled out and supported. In the alternative, we urge the IRS to revisit the impact this rule will have on the small businesses affected by this rule and promulgate a final rule that takes the actual costs to these businesses into account for the proposed safe harbor.

Very sincerely,

Jere W. Glover
Chief Counsel for Advocacy

Russell Orban
Assistant Chief Counsel