I. PURPOSE

The Treasury Department and the Internal Revenue Service (IRS) are reconsidering the method used to determine the adjusted applicable Federal rates (adjusted AFRs) under section 1288(b) of the Internal Revenue Code (Code) and the adjusted Federal long-term rate under section 382(f)(2). This notice requests comments from the public on what modifications should be made to the current method of determining such rates. To limit unintended effects of the current method under certain market conditions, this notice also provides interim guidance modifying the current method, which will apply pending future guidance.

II. BACKGROUND

A. Applicable Federal Rates

Section 1274(d) governs the determination of applicable Federal rates (AFRs) that are used for determining the imputed principal amount of obligations to which section 1274 applies, for computing total unstated interest on payments to which section 483 applies, and for other purposes. Under section 1274(d)(1), the AFR is: (i) in the
case of a debt instrument with a term not over three years, the Federal short-term rate; (ii) in the case of a debt instrument with a term over three years but not over nine years, the Federal mid-term rate; and (iii) in the case of a debt instrument with a term over nine years, the Federal long-term rate. Section 1274(d)(1)(B) requires the Secretary to determine during each calendar month the foregoing rates that shall apply during the following calendar month. The IRS publishes the AFRs for each month in the Internal Revenue Bulletin, as described in section 1.1274-4(b) of the Income Tax Regulations.

Section 1288(b) provides that, in applying section 483 or section 1274 to a tax-exempt obligation (as defined in section 1275(a)(3)), under regulations prescribed by the Secretary, appropriate adjustments shall be made to the applicable Federal rate to take into account the tax exemption for interest on the obligation. Although no regulations have been issued under section 1288, the IRS also publishes the adjusted AFRs (determined as described below under “Adjustment of Rates”) for each month in the Internal Revenue Bulletin.

B. Section 382

In the case of a corporation that has undergone an ownership change described in section 382(g): (i) section 382 places an annual limit (the section 382 limitation) on the amount of the corporation’s taxable income that can be offset by certain net operating loss carryforwards and other tax attributes; and (ii) section 383 places a limit, determined by reference to the section 382 limitation, on the amount of the corporation’s income tax liability that can be offset by certain tax credits and other tax attributes. Under section 382(b)(1), the section 382 limitation for a tax year ending after an
ownership change generally equals the product of (A) the value of the stock of the corporation immediately prior to the ownership change, and (B) the long-term tax-exempt rate.

Section 382(f)(1) provides that the long-term tax-exempt rate shall be the highest of the adjusted Federal long-term rates in effect for any month in the three-calendar-month period ending with the calendar month in which the ownership change occurs. Section 382(f)(2) provides that the term "adjusted Federal long-term rate" means the Federal long-term rate determined under section 1274(d), except that sections 1274(d)(2) and (3) shall not apply, and such rate shall be properly adjusted for differences between rates on long-term taxable and tax-exempt obligations.

The Conference Report for the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2254, which added section 382(f)(2) to the Code, indicates that the adjusted Federal long-term rate is to be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years. 2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-188 (1986), 1986-3 C.B. (Vol. 4) 188. The report also explains that it is necessary to the purposes of section 382 that the long-term tax-exempt rate is lower than the long-term Federal rate, and that the long-term tax-exempt rate would ordinarily be lower by a percentage that is less than the corporate tax rate. Id.

C. Adjustment of Rates Since 1986

The Treasury Department has determined the adjusted AFRs described in section 1288(b)(1) and the adjusted Federal long-term rate described in section
382(f)(2) in the same manner since those rates were first published for November 1986. See Rev. Rul. 86-133, 1986-2 C.B. 59; Rev. Rul. 86-135, 1986-2 C.B. 150. The adjusted Federal long-term rate published under section 382(f)(2) is equal to the long-term adjusted AFR with annual compounding published under section 1288(b) in the same month. (The long-term tax-exempt rate prescribed by section 382(f)(1) is also published each month; it is equal to the highest of the adjusted Federal long-term rates for that month and the two preceding months.)

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

The adjustment factor uses prime, general obligation tax-exempt bonds in the numerator because, at the time the adjustment factor was created, such obligations were of a comparable credit quality with U.S. Treasury obligations. The Treasury Department is aware, however, that there is a difference in perceived credit risk between U.S. Treasury obligations and even the highest grade tax-exempt bonds. That difference affects the relative yields of the tax-exempt bonds and the U.S. Treasury obligations represented in the adjustment factor in a way that offsets the effect of the tax exemption for the tax-exempt bonds. When the Treasury Department began using the
adjustment factor, the effects of the credit spread were negligible, yields of tax-exempt bonds were consistently lower than those of U.S. Treasury obligations, and the adjustment factor produced adjusted AFRs and adjusted Federal long-term rates that were lower than the corresponding AFRs by percentages that were significant but smaller than the highest corporate tax rates.

In the last several years, however, the credit spread between U.S. Treasury obligations and most other obligations, including tax-exempt bonds, has grown appreciably. Consequently, since the beginning of 2008, market yields of prime, general obligation tax-exempt bonds have often exceeded those of comparable U.S. Treasury obligations, and the adjusted AFRs and adjusted Federal long-term rate have often exceeded the corresponding AFRs. Those results show that the adjustment factor no longer serves the purposes of sections 1288(b)(1) and 382(f)(2), which contemplate adjustments to reflect tax exemption but not credit quality. The rates are also inconsistent with the express intention of Congress that the adjusted Federal long-term rate and long-term tax-exempt rate be lower than the Federal long-term rate.

D. Possible Modification of Adjustments

The IRS and Treasury Department are considering how the method for determining adjusted AFRs and the adjusted Federal long-term rate should be modified so that the method will be: (i) consistent with the purposes of sections 382(f) and 1288, even as market conditions and tax rates change; and (ii) based on readily available data. To satisfy these objectives, the adjustment factor may be modified to use different types of obligations in the numerator, denominator, or both, or a new methodology may
be implemented. The IRS and Treasury Department are also considering whether rates
determined using the current adjustment factor or a modified version should be subject
to any caps, floors, or other adjustments to ensure that the rates are determined in a
manner consistent with the requirements of sections 1288(b)(1) and 382(f)(2). Finally,
the IRS and Treasury Department are considering whether the adjusted Federal long-
term rate described in section 382(f)(2) should continue to be determined in the same
manner as the adjusted AFRs described in section 1288(b)(1).

Among the options for determining the adjusted AFRs and the adjusted Federal
long-term rate that the IRS and Treasury Department are considering are the following:

1. Determine the rates using the current methodology, with two modifications.
   First, the adjustment factor would be subject to a cap at one, such that no
   adjusted AFR or adjusted Federal long-term rate can ever exceed the
   corresponding AFR. Therefore, when the yield of the tax-exempt bonds
   exceeds that of the taxable obligations, the adjustment factor will be one.
   Second, if the yield of the obligations usually used in the denominator of the
   adjustment factor is ever zero or a negative number, the adjustment factor
   would be one.

2. Use an adjustment factor based on tax rates. Specifically, each adjusted AFR
   and the adjusted Federal long-term rate would be the product of (A) the
   appropriate AFR, and (B) the excess of (i) one hundred percent, over (ii) an
   appropriate tax rate. Such tax rate might be the highest corporate tax rate in
   section 11(b), or a fixed percentage of the highest corporate tax rate (if a fixed
percentage more reliably approximates the effect of tax exemption on market yields).

3. Use an adjustment factor in which the rates reflect equivalent credit qualities. For example, the denominator might be the LIBOR swap rate or a similar published rate. The numerator might be the yield of a pool of tax-exempt bonds determined by the Treasury Department to reflect the same credit quality and maturity as the rate in the denominator.


5. Use some combination of elements from the above approaches.

III. COMMENTS

The IRS and Treasury Department request comments on the possible modifications to the method by which adjusted AFRs and the adjusted Federal long-term rates are determined. Comments must be submitted by April 26, 2013. All materials submitted will be available for public inspection and copying. Comments should be submitted to Internal Revenue Service, CC:PA:LPD:PR (Notice 2013-4), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier’s Desk, 1111 Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:PR (Notice 2013-4), Room 5203. Submissions may also be sent electronically via the internet to the following e-mail address:
Notice.Comments@irscounsel.treas.gov. Include the notice number (Notice 2013-4) in both the subject line of the email and the body of the comment.

IV. INTERIM GUIDANCE

Until the IRS and Treasury Department issue further guidance, the adjusted AFRs, the adjusted Federal long-term rate, and the long-term tax-exempt rate will continue to be determined using the adjustment factor in the manner described above under “Adjustment of Rates,” except that the adjustment factor shall equal one for any month in which (A) the adjustment factor would otherwise exceed one, or (B) the denominator of the adjustment factor would otherwise be zero or a negative number.

The modifications described above will be reflected in the monthly revenue rulings in which the adjusted AFRs and the adjusted Federal long-term rate are published, beginning with the rates for March 2013.

V. DRAFTING INFORMATION

The principal author of this notice is Steven Harrison of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice contact Mr. Harrison at (202) 622-3930 (not a toll-free call).