Lesson 2

Statutory Framework / Introduction to the Deskbook

Overview

Purpose

This lesson provides an overview of the structure of the Internal Revenue Code (Code or IRC), focusing on the principal IRC sections related to tax-advantaged bonds. After a brief review of legal research methods and resources, this lesson describes the statutory structure of relevant Code sections and an example of one analytical framework that the student might use in approaching the Code with respect to legal questions related to tax-advantaged bonds. The student will explore relevant Code sections in the Federal Taxation of Municipal Bonds Deskbook in order to identify the resources available in the Deskbook.

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Overview, Continued

Objectives

At the end of this lesson, you will be able to:

- List the Code sections specifically related to tax-advantaged bonds
- Name the subjects covered by each of the Code sections specifically related to tax-advantaged bonds
- Use the basic analytical framework for evaluating issues related to tax- advantaged bonds
- Use the Deskbook to find statutory language and citations to legislative history

Contents

This lesson contains the following topics:

Section 1

Legal Research Review

Method

There are six steps in the tax research process. The six steps are: 1. determine the facts, 2. identify the issue or issues, 3. locate the applicable authorities, 4. analyze the authorities, 5. analyze the facts in reference to the applicable authorities, and 6. communicate your conclusions.

These six steps were discussed in Self-Study Course 4.

Authority: Sources of the Law

Primary authority is the law itself, such as statutes, cases, and regulations. Secondary authority is a description of the law, such as dictionaries, encyclopedias, practice materials, treatises, and law review articles. The law refers to more than the Internal Revenue Code. Notwithstanding its length, the Code does not provide detailed guidance. As a consequence, interpretations of the Code are necessary. There are both administrative and judicial interpretations. The term tax law as used by tax professionals encompasses all of these sources. It also includes committee reports issued by Congressional committees in the legislative process. These reports are very useful in determining the intent of the law, especially in interpreting new legislation that may have little or no judicial history or if the Treasury Department has not yet published regulations

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Getting Started

It is often helpful to start your research with the written materials you received in your IRS training. If the topic is not included in the written materials you received to date, the topic may be covered in training materials included on the Tax Exempt Bond Community page of the IRS website at www.irs.gov under the heading "Tax Exempt Bonds Forms, Publications, and Training Materials."

Another good starting point is the CD-ROM for the National Association of Bond Lawyers (NABL) Fundamentals of Municipal Bond Law. This seminar publication covers general municipal law, federal tax aspects of municipal bonds, securities laws, and professional responsibility.

The Internal Revenue Code (IRC or Code)

The IRC is Title 26 of the United States Code. The IRC is a statute, which can be changed by Congress. The IRC is interpreted by the Federal courts in judicial opinions, by the Treasury Department in Treasury Regulations, and in other administrative guidance published by the IRS. The IRC is constantly changing. Do not assume that any part of the statute remains the same as the last time you looked at it. Always check to be sure you are using the applicable version of the Code. Also, it is possible that the section of the Code you are dealing with has changed since the time the activities with which you are concerned occurred. You need to determine what the Code said, and what the law was, at the time of the events that are in question. Generally, unless otherwise provided, the applicable statute is the one in effect at the time the bonds were issued. Generally, the public law section that introduced the Code section into the Code (or sometimes the Code section itself) will have a provision relating to the effective date and applicability of the section. Thus, the Code is the first place to look for the answer to a tax law question.

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Example

You are examining a Build America Bond that was issued under § 54AA(g). Pursuant to that section, and § 6431, the issuer is entitled to receive directly from the Federal Government a credit payment equal to a percentage of the interest payable on the bond. The issuer has pledged the payments it expects to receive from the Federal Government to the payment of the debt service on the bonds.

You believe pledging payments received by the issuer directly from the Federal Government may be a partial federal guarantee of the bonds, which violates § 149(b). Section 149(b) provides that § 103(a) does not apply to a bond if the bond is federally guaranteed and that a bond is federally guaranteed if payment of debt service on the bond is guaranteed, even indirectly, in whole or in part by the United States.

The Code is the first place to look for the answer to your question regarding whether the bond is federally guaranteed and therefore not described in§ 103(a). You should look at the provisions of § 149(b), but before reaching your conclusion you should also look at § 54AA(d)(2)(A).

Has the issuer caused its bonds to fail to be described in § 103(a) by pledging the expected payments from the Federal Government to the payment of debt service in violation of § 149(b)? The Code answers your question.

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Other Tax Law Resources

Not every tax question can be answered by the literal language of the Code. At times the language of the Code is unavoidably ambiguous. Sometimes it is intentionally so, leaving the job of applying the law to a particular situation to those of us charged with doing so. When the literal language of the Code does not fully and finally answer a tax question, which occurs quite often, we look to the history of the Code section in question, the committee reports as they relate to that section and other legislative history, Treasury regulations, other IRS guidance, and the relationship of the section in question to other sections of the Code.

Section 2

Statutory Structure of Relevant IRC Sections

Structure of the Statute as it Relates to Tax-Advantaged Bonds

The IRC, itself a "title" of the United States Code, is divided into eleven subtitles, which are further divided into chapters, subchapters, parts, subparts, sections, subsections, paragraphs, subparagraphs, clauses, and subclauses.

The overall scheme of the statute as it concerns tax-advantaged bonds generally is as follows: Title 26 of the United States Code, referred to as the Internal Revenue Code, contains all matters concerned with taxation. Of the eleven subtitles within Title 26, subtitle A deals with income taxes. Chapter 1 of subtitle A sets out the law relating to normal taxes and surtaxes. Subchapter A of Chapter 1 is determination of tax liability. Part 1 of Chapter 1 deals with the tax on individuals, section 1 imposes a tax on all gross income. Subchapter B of Chapter 1 is computation of taxable income and
Part III of that subchapter lists items specifically excluded from gross income. Section 103 of Part III specifically excludes interest on state and local bonds from gross income.

Within the Code, the scheme for sections is as follows: for example, section 144(a)(12)(C)(ii)(II): 144 is the section; (a) is the subsection; (12) is the paragraph; (C) is the subparagraph; (ii) is the clause, and (II) is the subclause.

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§ 103 Stands Alone

Section 103 stands alone. The other sections of the IRC that concern tax-advantaged bonds do not immediately precede or follow § 103.

1986 Act

Section 103 stands alone because, as was mentioned in Self-Study Course 2, prior to the Tax Reform Act of 1986 (the “1986 Act”), all of the provisions related to tax-exempt bonds were contained in § 103. When the IRC of 1986 was drafted, instead of completely revising the IRC numbering system, Congress decided to place the new provisions related to tax-exempt bonds in their own part of the Code, Part IV of Subchapter B of Chapter 1 of Subtitle A of Title 26. See the graphic depiction of this location on the next page.

Other IRC Tax-Exempt Bond Provisions

Section 1394 authorized tax-exempt enterprise zone facility bonds in 1993 and empowerment zone facility bonds in 1997. Section 1400L authorized New York liberty Zone bonds in 2001 as relief after the terrorist attacks in New York City. Section 1400N(a) authorized qualified Gulf Opportunity zone bonds in the wake of Hurricane Katrina in 2005. Similar relief was provided in 2008 by authorizing the qualified Midwestern disaster bonds and qualified Hurricane Ike disaster area bonds. Section 1400U-3 authorized the recovery zone facility bonds in 2009.

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Tax Credit Bonds

At the time of the 1986 Act, tax-exempt bonds were the only type of tax-advantaged bond under the IRC. The provisions of § 1397E, authorizing the first tax credit bonds called qualified zone academy bonds were added in 1997. In 2005 the provisions of §§ 54 and 1400N(l) were added authorizing clean renewable energy bonds and Gulf tax credit bonds, respectively. In 2008 the provisions of §§ 54A through 54D were added and § 1397E was moved to § 54E authorizing qualified forestry conservation bonds, new clean renewable energy bonds, qualified energy conservation bonds and qualified zone academy bonds. Also in 2008, Midwestern tax credit bonds were authorized under section 1400N(l). Sections 54F, 54AA, and 1400U-2 were added in 2009 authorizing qualified school construction bonds, build America bonds, and recovery zone economic development bonds. In 2009 and 2010, under section 6431, Congress authorized tax credit to be received by issuers of certain tax credit bonds. Generally, other than the temporary relief provisions, tax credit bond provisions were placed, logically, in the part of the Code dealing with credits against tax, Part IV of Subchapter A of Chapter 1 of Subtitle A of Title 26.

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IRC Table of Contents; Principal IRC Sections Related to Tax-Advantaged Bonds

Title 26 – Internal Revenue Code

Subtitle A – Income Taxes

Chapter 1 – Normal Taxes and Surtaxes

Subchapter A – Determination of Tax Liability

Part IV – Credits Against Tax

Subpart H – Nonrefundable Credit to Holders of Clean Renewable Energy Bonds

Section 54 – Credit to holders of clean renewable energy bonds

Subpart I – Qualified tax credit bonds

Section 54A – Credit to holders of qualified tax credit bonds

Section 54B – Qualified forestry conservation bonds

Section 54C – New clean renewable energy bonds

Section 54D – Qualified energy conservation bonds

Section 54E – Qualified zone academy bonds

Section 54F – Qualified school construction bonds

Subpart J – Build America Bonds

Section 54AA – Build America bonds

Subchapter B – Computation of Taxable Income

Part III – Items Specifically Excluded From Gross Income

Section 103 – Interest on State and local bonds

Part IV - Tax Exemption Requirements for State and Local Bonds

Subpart A – Private activity bonds

Section 141 – Private activity bond; qualified bond

Section 142 – Exempt facility bond

Section 143 – Mortgage revenue bonds: qualified mortgage bond and qualified veterans' mortgage bond

Section 144

Subsection 144(a) – Qualified small issue bond

Subsection 144(b)– Qualified student loan bond

Subsection 144(c) – Qualified redevelopment bond

Section 145 – Qualified 501(c)(3) bond

Section 146 – Volume cap

Section 147 – Other requirements applicable to certain private activity bonds

Statutory Structure, Continued

IRC Table of Contents; Principal IRC Sections Related to Tax-Advantaged Bonds (continued)

Subpart B – Requirements applicable to all State and local bonds
Section 148 - Arbitrage
Section 149 – Bond must be registered to be tax exempt; other requirements
Subpart C – Definitions and special rules
Section 150 – Definitions and special rules
Subchapter U – Designation and treatment of empowerment zones, enterprise communities, and rural development investment areas
Part II – Tax-exempt facility bonds for empowerment zones and enterprise communities
Section 1394 – Tax-exempt enterprise facility bonds
Part IV – Incentives for education zones
Section 1397E – Credit to holders of qualified zone academy bonds
Subchapter W – District of Columbia enterprise zone
Section 1400A – Tax-exempt economic development bonds
Subchapter Y – Short-term regional benefits
Part I – Tax benefits for New York Liberty Zone
Section 1400L – Tax benefits for New York Liberty Zone
Part II – Tax benefits for GO zones
Section 1400N – Tax benefits for Gulf Opportunity zone
Part III –
Section 1400U-1 - Allocation of recovery zone bonds
Section 1400U-2 – Recovery zone economic development bonds
Section 1400U-3 – Recovery zone facility bonds

Section 3

Analytical Framework

Necessity

The need for a framework to analyze the statute is sufficiently important that it bears stating. In order to guide your analysis to the correct provision of the statute, you must start at the beginning of the analytical framework and follow it to the correct provision. If you start your analysis at the wrong place you may end up analyzing a provision that looks like it affects the facts of your case, but which does not apply to your case at all. Even experienced practitioners use an analytical framework when approaching the statute.

Decision Tree

The NABL Fundamentals of Municipal Bond Law text contains a Tax Inquiry Flowchart designed to assist the practitioner in identifying federal tax questions for tax-advantaged bond issues. You should print a copy of the flowchart and keep it handy. It operates as a "decision tree." Start at the beginning with the questions of whether the issuer is valid and whether the debt is valid and follow the arrows in the direction that corresponds to the answers you give to the questions asked. When you reach the bottom of the page you will have identified the type of bond issue and some of the pertinent questions with which you are dealing. The flowchart is not itself an analytical framework. It is a tool that helps you in implementing the correct analytical framework.

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Analytical Framework, Continued

Basic Analytical Framework: Start with § 103(a)

The basic analytical framework is based on the provisions of the Code. Start at § 103(a) and ask a series of questions that arise from the text of the statute. Are you dealing with interest? Are you dealing with a bond? Is it a state or local bond? Take a careful look at § 103(a) and be certain you know what language of the statute these question relate to.

Next, §103(b)(1)

Now move on to § 103(b)(1). Is it a private activity bond? You need to look at § 141. If yes, is it a qualified private activity bond? You need to look at § 141(e). Is the bond of the type listed in § 141(e)(1)(A) through (G)? If so, you need to look at the following Code sections that correspond to the types of bonds listed in § 141(e)(1)(A) through (G):

- Exempt facility bond - § 142
- Qualified mortgage bond - § 143
- Qualified veterans' mortgage bond - § 143
- Qualified small issue bond - § 144(a)
- Qualified student loan bond - § 144(b)
- Qualified redevelopment bond - § 144(c)
- Qualified 501(c)(3) bond - § 145

That Leads to §141(e)(2) and §141(e)(3)

Now move on to § 141(e)(2). Does the bond you are looking at satisfy the requirements of § 146 relating to volume cap? The next question is based on § 141(e)(3). Does the bond you are looking at satisfy the requirements of each subsection of § 147?

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Analytical Framework, Continued

Analytical Framework Corresponds to Structure of the IRC

The questions you are asking and the analytical framework you are using follow the order of the numbered sections in the statute.

Move on to §103(b)(2) and § 103(b)(3)

Once you are done with questions that relate to § 103(b)(1), move to § 103(b)(2). Is the bond an arbitrage bond? You need to look at § 148. From there you move on to § 103(b)(3) and examine whether the requirements of § 149 are satisfied.

Only a Framework

The approach just outlined is only the framework for the analysis.

For each section mentioned, of course, there are many questions that must be asked and answered in order to determine whether the section affects your facts. The basic framework, however, starts with § 103.

Similarly, for other tax-exempt bonds, the basic analytical framework and starting point is the IRC section relating to those bonds, such as § 1394 for enterprise zone bonds, § 1400L for New York Liberty Zone bonds,
§ 1400N(a) for GO zone, Midwestern and Hurricane Ike bonds, and § 1400U-3 for recovery zone facility bonds.

Tax Credit Bonds: Same

For tax credit bonds you proceed in the same way. Start at the beginning of § 54, § 54A, B, C, D, E, or F, § 54AA, or § 1400U-2, as appropriate, and follow the terms of the statute from beginning to end just like you would with §103.

Section 4

Review of the Deskbook

About the Deskbook	The Deskbook, titled “Federal Taxation of Municipal Bonds Deskbook,” is a compilation of primary sources of law on tax-advantaged bonds compiled and published by NABL.
Notes Following Each Section	Each Code section presented in the Deskbook is followed by notes relating to that section’s statutory history; effective dates, transition rules, and noncodified provisions, cross-references, prior law, and legislative history.
Statutory History	The notes related to statutory history indicate the public law in which each section of the Code was contained as originally enacted and as subsequently amended.
Effective Dates, Transition rules and Noncodified Provisions	The United States Code is, as its name suggests, a codification of the law. There are provisions of the tax law that are not found in the United States Code version of the statute, such as effective date, applicability, and transitional provisions. Nevertheless, such noncodified provisions (i.e., “off- Code” provisions) are part of the statute and have equal dignity and controlling authority with the codified portions of the statute. Note [3] (Effective Dates, Transition Rules and Noncodified Provisions) following § 143 in your Deskbook is a good example.
Cross-References	“Cross-references,” as used in the Deskbook, means cross-references to this section of the statute in other sections of the IRC and in other federal statutes. Note [4] (Cross-References) following § 103 is a good example.

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Prior Law

Prior law refers to the provisions of the Internal Revenue Code of 1954 (the "1954 Code"). Generally, the provisions of the 1954 Code apply to bonds issued prior to the effective date of the 1986 Act and to bonds that are subject to the transitional provisions of the 1986 Act. These notes are not helpful without a copy of Volume 5 of the Federal Taxation of Municipal Bonds series, to which the majority of agents and specialists in TEB do not have access.

Legislative History

Federal income tax legislation always originates in the House of Representatives. Hearings on the bill are held by the House Ways and Means Committee. When a bill is introduced in the House, a Committee Report is published that often states the reason the bill is being proposed. This reasoning establishes the legislative intent behind the final law. After the bill is approved by the House, it is considered by the Senate which also has a committee that holds hearings and prepares a report explaining changes made to the House bill, the Senate Finance Committee.

Later a Conference Committee resolves the differences between the House and Senate versions and issues its own report.

Each of these reports can be useful in clarifying the meaning of the language used in the statute. Citations to any applicable report relating to the legislation are included in Note [6] following each section of the Code.

Treasury Regulations

Each section of the Code that appears in the Deskbook is followed by applicable Treasury Regulations related to that section. As you learned in the Self-Study Course on tax law research, following the Code itself, the most important tax law research resource you have are the Treasury Regulations.

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Interpret Code; Types of Regulation

The regulations assist in interpreting the Code. The regulations often contain examples that assist in understanding the statutory language of the Code. The regulations are issued as proposed, temporary, and final. Some of the applicable regulations relate to the 1954 Code provisions and are applied to the extent that they are not inconsistent with the applicable provision of the 1986 Act.

Proposed Regulations

Proposed Regulations are issued to allow for suggestions and comments from the public. Although proposed regulations represent Treasury's official interpretation of the Code, they carry no more weight than the arguments the IRS would make in a court brief. Occasionally, to provide guidance and some certainty in an unsettled area of the law, Treasury may issue proposed regulations upon which, when the proposed regulations specifically so provide, issuers and other taxpayers may rely.

Temporary Regulations

Temporary Regulations are issued as a Treasury Decision with the purpose of having an immediate legal effect, but their effectiveness, generally, expires by force of law in 3 years after publication. Temporary regulations may be accompanied by corresponding proposed regulations and generally are followed by final regulations.

Final Regulations

Final Regulations are drafted after the public has had the opportunity to comment on the proposed version. Final Regulations are adopted by a Treasury Decision which contains a preamble or supplementary information discussing background, comments, and an explanation of provisions.

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Review of the Deskbook, Continued

Other Substantive IRC Sections in the Deskbook

In addition to the chapters in the Deskbook containing §§ 103 and 104 through 150, there are also chapters in the Deskbook containing the "tax credit sections" (§§ 54 through 54F and § 6431) and sections authorizing other miscellaneous tax-advantaged bonds (§§ 1391 through 1400U-3).

Indian Tribal Government Bonds

The Deskbook includes a separate chapter that contains § 7871 relating to bonds issued by Indian Tribal Governments, including Tribal Economic Development Bonds.

Issue Price and Marketability

Several Code sections that affect the issue price of bonds are included as are the Code provisions that are designed to control the volume of bond issuance through demand-side mechanisms that affect the marketability of bonds.

Transition Rules and Effective Dates

TEB examines questions over twenty years after the enactment of the 1986 Act regarding the meaning of the language in a transition rule from the 1986 Act. Although the enactment of the IRC of 1986 was decades ago, there likely will be questions from time to time that will be affected by one or more transition rules. The Deskbook contains the transition rules and effective dates for the 1986 Act under the heading of "1954 Code."

Revenue Rulings, Revenue Procedures, and Revenue Notices

The significant revenue rulings, revenue procedures, and revenue notices relating to tax-advantaged bonds are reproduced in the Deskbook.

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Using the Deskbook: Exercise 1

Assume that the current version of the IRC is applicable.

The bonds you are examining were issued by the City to finance a public park as part of an extensive park system all of which has been financed by bonds that purport to be tax-exempt bonds. The bond issue you are looking at was issued in the principal amount of $30,000,000 and is clearly not a qualified hospital bond. The bond issue you are looking at, when added to the principal amount of the other bonds issued for the park system within the three years prior to the date of issuance will exceed $150,000,000. Additionally, other capital expenditures made by the City on the park system during those three years and expected to be made during the three years following the date of issuance of the bonds you are examining will clearly exceed $40,000,000. You recall there is a provision in the Code that limits the amount of bonds other than hospital bonds to $150,000,000 and a provision limiting the aggregate face amount of qualified small issue bonds to $40,000,000.

Using the analytical framework discussed in this lesson, determine whether either of the $150,000,000 limitation or the capital expenditure limitation related to small issue bonds is applicable. Why or why not?

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Using the Deskbook: Exercise 2

Assume that the current version of the IRC is applicable.

You are looking at a bond issue that financed a terminal expansion and an additional runway at a county airport. The construction will likely take an extended period of time. How far in the analytical framework can you get before you need additional information? Why? What information do you need in order to get to at least the next major set of questions?

Using the Deskbook: Exercise 3

Assume that the current version of the IRC is applicable.

You have concluded that the bond issue you are looking at is a qualified hedging transaction pursuant to Regulations § 1.148-4(h). On that basis, should you jump to § 149(g) which describes the treatment of hedge bonds in order to determine whether the bonds in question are tax-exempt? Why or why not? Describe how the analytical framework discussed in this lesson would help you reach the correct answer to this question.

Summary

Review of Lesson 2

In this lesson you studied an overview of the structure of the Internal Revenue Code, which focused on the principal Code sections related to tax-advantaged bonds. You were introduced to an example of one analytical framework that you might use in approaching the Code with respect to legal questions related to tax-advantaged bonds. You explored relevant Code sections in the Deskbook in order to identify the resources available in the Deskbook.

Preview of Lesson 3

In Lesson 3 you will examine the important questions of whether the issuer is an eligible issuer of tax-advantaged bonds (valid issuer) and whether the debt has the characteristics necessary for it to be eligible to qualify as tax-advantaged debt (valid debt).

Entities that are qualified to issue tax-exempt bonds are:

- states and political subdivisions, and
- on behalf of issuers

In order to be tax-exempt, the debt must possess certain characteristics. The debt must:

- be valid under state law
- be an exercise of borrowing power
- result from an intent to make a loan
- be an obligation regardless of the source of repayment, and
- include payments treated as interest for federal tax purposes

Lesson 3 discusses all of these concepts.

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