OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Remarketed Bonds Secured by U.S. Treasury Securities

This responds to your memorandum dated February 14, 2000, requesting supplemental Field Service Advice. Field Service Advice was previously issued with respect to this matter on March 11, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Partnership =
Development =
Town =
Districts =

State =
District A =

Corporation =
Bonds 1 =
Bonds 2 =

Year 1 =
Year 2 =

Year 3	=
Year 4	=
Year 5	=
Date 1	=
Date 2	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=

ISSUES:

1. Whether the information provided supports a determination that the transaction enabled the parties to exploit the difference between tax-exempt and taxable rates.

2. Whether the remarketing of the bonds resulted in a reissuance.

CONCLUSION:

1. Based on the documentation provided and your representations, there is a strong argument that the transaction enabled the parties to exploit the difference between tax-exempt and taxable rates. This result is inconsistent with section 103 of the Internal Revenue Code.

2. The changes to the bonds after remarketing appear so material as to amount to the issuance of new securities. Further, as the bonds in question were reissued at a yield lower than the investments, the bonds appear to be arbitrage bonds.

FACTS:

Partnership was the original developer and owner of Development located within Town. In Year 1, Partnership acquired a acres of real property within the boundaries of the Development for approximately $b, or less than $c per acre.

In Year 2, the Districts were organized to provide water, sewer, street, park, safety, and recreation improvements within the Development. Districts are quasi-municipal corporations created under the laws of State and are political subdivisions. State law requires preparation and approval of a service plan for the organization of a District. A service plan consists of financial and engineering surveys showing how the District will provide and finance the proposed services.

In Year 3, District A issued its Bonds 1, general obligation bonds in the original principal amount of $d. Bonds 1 were secured in part by taxes, service charges, and development fees. In connection with the issuance of Bonds 1, Partnership entered into a Development Fee Agreement wherein it agreed to pay a total of $e to District A for the right to use its facilities. The fees due District A under the Development Fee Agreement were projected to be the primary source of repayment of Bonds 1 until development produced enough revenues to pay debt service from reasonable mill levies on taxable property within District A.

Subsequently, in Year 4, Partnership defaulted on its obligations under the Fee Agreement with District A and filed for bankruptcy protection. At the time of Partnership's bankruptcy, no home construction or other development had begun within the geographic boundaries of District A. Further, assessed valuation of property in District A was approximately $f. Without collecting the anticipated fees from Partnership, District A concluded that a levy of approximately g mills on taxable property within District A would have been necessary to pay the debt

service on Bonds 1. Its Board believed the levy was uncollectible and District A filed a Chapter 9 bankruptcy petition on Date 1.

After Partnership and District A filed for bankruptcy, each of the Districts and Town executed an agreement requiring each District to submit an amendment to its service plan before any future development may begin within the Development. Town will not formally consider the amendments to any District's Service Plan until all Districts amend their service plans. Information previously received from your office indicates that Town has not approved amendments to any of the Districts' service plans and no construction has begun in Development.

In Year 5, District A received relief from the Bankruptcy Court to foreclose on its lien against Partnership's property arising under the Development Fee Agreement. An appraisal obtained by District A at that time valued approximately h acres of the property at $i, or approximately $j an acre, slightly more per acre than the amount Partnership originally paid in Year 1. After acquiring the property, District A pledged it to the payment of Bonds 1.

On Date 2, the Bankruptcy Court approved District A's plan for emerging from bankruptcy. Under District A's reorganization plan, the holders of Bonds 1 received the following:

(a) the pro rate distribution of the unexpended Bonds 2 proceeds in the amount of approximately $k (or approximately $l per dollar of the creditor claims); and

(b) an exchange refunding bond for the remaining portion of their claims.

After confirmation of its bankruptcy plan, District A issued its Bonds 2, the exchange refunding bonds, in the amount of $m for the purpose of exchanging them for Bonds 1. Bonds 2 are limited tax obligations payable from District A's revenues. Bonds 2 are also secured by a mortgage encumbering the property acquired by District A from Partnership ('the Property"). District A's records for Year 5 show that the Property had a value of $n.

Bonds 2 do not pay current interest during their term, but rather pay principal and accreted interest on the maturity date. The Form 8038-G filed for Bonds 2 reports that the yield on the bonds is o percent.

At substantially the same time as the issuance of Bonds 2, Corporation made a tender offer to purchase Bonds 2 from the bondholders for $p per dollar. The tender offer made to the holders of Bonds 2 states that Corporation has no present

plan to remarket the bonds. Corporation eventually purchased substantially all Bonds 2. The bankruptcy plan filed by District A indicated that the holders of Bonds 2 may receive an additional $p per dollar of outstanding principal from Corporation if they approved the plan.

With the purchase of Bonds 2, Corporation purchased from District A the Property. A total of q acres was sold for $r, approximately $s per acre. This amount is nearly 10 times the amount per acre similar property was appraised for in Year 5. District A deposited with the trustee of Bonds 2 the proceeds from the sale of the Property. District A used the proceeds to purchase U.S. Treasury securities to defease Bonds 2. The yields on the securities reportedly range from t percent to u percent. Corporation remarketed Bonds 2 to individual investors for $v. After the remarketing, the yield on Bonds 2 is approximately w percent.

LAW AND ANALYSIS:

1. Rev. Rul. 94-42

Section 103(a) of the Internal Revenue Code provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Treas. Reg. § 1.103-1 provides that interest on obligations of a state, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof is not includable in gross income except as otherwise provided.

The exclusion from gross income of interest on obligations of states and political subdivisions thereof is not all-embracing and applies only where consistent with the purposes of section 103. See, United States Trust Co. of New York v. Anderson, 65 F.2d 575, 579 (2d Cir. 1933). An overriding purpose of section 103 is to enable state and local governments to borrow at subsidized interest rates to carry out governmental purposes. Rev. Rul. 94-42, 1994-2 C.B. 15.

Rev. Rul. 94-42 provides that amounts paid or accrued under an agreement guaranteeing payment on bonds is not excludable from gross income under section 103 if the agreement is not incidental or is in substance a separate debt instrument or similar investment when purchased. An agreement is considered as both incidental and not a separate debt instrument or similar investment only if, at the time it is purchased, the amount paid to obtain the agreement is reasonable, customary, and consistent with the reasonable expectation that the issuer of the bonds, rather than the insurer, will pay debt service on the bonds.

In Rev. Rul. 94-42, a County issued zero coupon bonds having a 30 year maturity and a stated redemption price of $204x. The bonds were payable solely from the revenues of the facility acquired with the bonds. At the time of issuance, there was significant risk that revenues from the facility would be insufficient to pay debt service.

In an unrelated transaction, M, the sole holder of the bonds, entered into an agreement with G. Under the agreement, M paid G 14x in exchange for G guaranteeing the payment of all scheduled debt service on the bonds to M or any subsequent holders. G then purchased 14x of U.S. Treasuries, in connection with its agreement with M. The Treasuries had a yield of 9.6%. The Treasuries were transferred to a trust to secure the payment of the bonds. The principal and interest on the Treasuries will be sufficient to pay off all debt service on the bonds.

The agreement with G allowed M to obtain the highest rating for the bonds from a national rating agency. M then sold the bonds to the general public for a price of $20x, giving the purchasers an annual yield of approximately 8.3%.

According to Rev. Rul. 94-42, treating the amounts paid or accrued under the G agreement as excludable from gross income would, in substance, permit either G, the issuer of the purported insurance, or M, the purchaser of the purported insurance, to obtain the benefit of borrowing at a tax-exempt rate and investing the proceeds at a taxable rate. Obtaining the benefit of borrowing at tax-exempt rates provided the arbitrage benefit and assured the economic viability of the purported bond insurance arrangement. This result is inconsistent with the purposes of section 103. Amounts paid or accrued under an agreement guaranteeing payment on bonds is not excludable from gross income under section 103 if the agreement is not incidental or is in substance a separate debt instrument or similar investment when purchased.

Based on the information provided, the economic substance of this transaction is analogous to the transaction in Rev. Rul. 94-42. At the time of issuance of Bonds 2, there was significant risk that revenues from District A would be insufficient to pay debt service. As development had not begun, there was no tax base. In addition, District A's own records indicate that the value of the Property securing Bonds 2 was $n. Ostensibly, Corporation was able to purchase Bonds 2 from bondholders for $p per dollar due to this risk.

Further, the subsequent sale of the Property to Corporation for r appears to be nothing more than a device to provide District A with sufficient funds to defease Bonds 2 with the U.S. Treasury securities, thus, increasing their marketability. The device enabled Corporation to remarket Bonds 2 at a premium so that the yield on

the remarketed Bonds 2 was materially lower than that on the Treasury securities. District A's participation provided Corporation with the opportunity to exploit the difference between tax-exempt and taxable interest rates.

Accordingly, this transaction (the sale agreement between District A and Corporation, the defeasance of Bonds 2 and the subsequent remarketing of Bonds 2 at a premium) was not incidental to the issuance of Bonds 2, but resulted in a separate debt instrument or investment when remarketed. From the information provided, the amount paid for the Property does not appear to reflect its fair market value, but rather the amount necessary to defease Bonds 2. The defeasance, in turn, effectively guaranteed the payment of debt service on Bonds 2, enabling Corporation to remarket Bonds 2 at a premium, thereby assuring the economic viability of the transaction. Treating interest on the remarketed Bonds 2 as tax-exempt would effectively permit Corporation to obtain the benefit of borrowing at tax-exempt rates. This result is inconsistent with the intent of section 103.

2. Reissuance

Section 103(b)(2) provides that subsection (a) of section 103 shall not apply to any arbitrage bond, within the meaning of section 148. Section 148(a) defines the term 'arbitrage bond' to mean any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

For purposes of section 148(a), a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in section 148(a)(1) or (2). The taking of any deliberate, intentional action by the issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional. Treas. Reg. §1.148-2(c).

As discussed in the prior Field Service Advice, the sale of the Property, the defeasance of Bonds 2 and their subsequent remarketing resulted in a reissuance because the underlying arrangement with District A resulted in a change to the terms of Bonds 2 that is so material as to amount to the issuance of a new security.

Section 1001 governs for determining when securities received in exchange for securities surrendered in a transaction gives rise to a gain or loss. The standard, under Treas. Reg. § 1.1001-1(a), for determining whether an exchange of property is a disposition is whether the properties exchanged differ materially either in kind or extent. Where the changes are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if a new security were actually issued. Rev. Rul. 81-169, 1981-1 C.B. 429.[1]

In this case, the sale of the Property securing Bonds 2 to Corporation provided District A with sufficient funds to defease Bonds 2. This enabled Corporation to remarket Bonds 2 at a premium, reducing the effective yield on Bonds 2 from o percent to approximately w percent. Prior to the sale agreement between Corporation and District, the repayment of Bonds 2 was speculative. In addition to the fact that there was no reasonably anticipated source of revenues to pay debt service, the land securing Bonds 2 had a book value of only $n. After the sale of the property, apparently at an inflated price, debt service Bonds 2 was guaranteed by the investment in U.S. Treasury securities, a fact reflected by the nearly 7 percent drop in the yield on Bonds 2 after remarketing.

Accordingly, as a result of the sale of the property to Corporation and the guarantee of the payment of debt service on Bonds 2, the legal entitlements on Bonds 2 after the defeasance and remarketing were sufficiently distinct from those originally associated with Bonds 2 to cause a disposition under section 1001. See Cottage Savings Assn. v. Commissioner, 499 U.S. 554 (1991). Evidence of a reissuance includes the change in payment expectations as result of the defeasance of the bonds and the resulting change in yield.[2] The consequence of treating the remarketed Bonds 2 as a reissuance is that the yield on the U.S. Treasury securities is materially higher than the yield on the reissued bonds. Thus, it appears the bonds would be arbitrage bonds.

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[1] For alterations of the terms of a debt instrument on or after September 24, 1996, Treas. Reg. § 1.1001-3 addresses when a modification of a debt instrument is deemed to cause an exchange for purposes of section 1.1001-1(a) of the regulations. The provisions of this section may also be relied on for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

[2] This conclusion is also consistent with current regulations. For example, under section 1.1001-3(e), significant modifications include changes in yield of more than 0.25 percent.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Based on the information provided, it is our opinion that, under the principles enunciated in Rev. Rul. 94-42, there is a strong argument that this transaction is inconsistent with the intent of section 103. The Form 8038-G filed by District A evidences that the yield on Bonds 2 was o percent prior to the remarketing. The yield on the Treasuries was between t and u percent. The Remarketing Memorandum for Bonds 2 indicates that the remarketed bonds will have a yield of approximately w percent. These facts, coupled with the questionable financial history of both the Development and the District, create a compelling argument that this transaction enabled Corporation to exploit the difference between tax-exempt and taxable rates. The overpayment by Corporation for the property assures the economic viability of the transaction by providing District A with the funds to guarantee the payment of Bonds 2, thus, increasing their marketability.

First, the Service's position articulated in Rev. Rul. 94-42 has not been addressed by any court. While the principles set forth in Rev. Rul. 94-42 are fairly fundamental to section 103,

In addition, the current transaction occurred prior to the publication of Rev. Rul. 94-42. Generally, however, revenue rulings are retroactive unless the Commissioner specifically provides otherwise. The parties may argue relief from retroactive relief from the application of Rev. Rul. 94-42.

The facts must establish that the changes to Bonds 2 are so material as to amount virtually to the issuance of a new security. The issuer will presumably argue that there is no prohibition against establishing the defeasance for Bonds 2 and that the subsequent remarketing of the bonds at a premium merely reflects their increased value on the secondary market. In addition, current regulations addressing when a reissuance occurs specifically state that a "defeasance of tax-exempt bonds is not a significant modification . . . if the defeasance occurs by operation of the terms of the original bond and the issuer places in trust government securities . . . that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligation under the bond." Treas. Reg. § 1.1001-3(e)(5)(ii)(B).

Please call if you have any further questions.

By: Joel E. Helke

JOEL E. HELKE
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cc: