INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 148.00-00
CASE-MIS No.: TAM-114520-14

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Refunding Bonds =

Issue Date =

Issuer =

a =

b =

c =

Date 1 =

Period 1 =

d =

e =

ISSUE(S):

1. Was an abusive arbitrage device, as defined in § 1.148-10(a)(2) of the Income Tax Regulations, used in connection with the Refunding Bonds?

2. Does either the Reserve Portion or the Current Portion of the Refunding Bonds constitute excess gross proceeds under § 1.148-10(c)(2)?

3. Are the Refunding Bonds an advance refunding in which a device was employed to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates, as described in § 149(d)(4) of the Internal Revenue Code (the Code)?

CONCLUSION(S):

1. No abusive arbitrage device, as defined in § 1.148-10(a)(2), was used in connection with the Refunding Bonds.

2. Neither the Reserve Portion nor the Current Portion of the Refunding Bonds constitutes excess gross proceeds under § 1.148-10(c)(2).

3. The Refunding Bonds are not an advance refunding in which a device was employed to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates, as described in § 149(d)(4).

FACTS:

On the Issue Date, the Issuer issued the Refunding Bonds to advance refund a portion of the Issuer's outstanding indebtedness (the Refunded Bonds). By statute, the Issuer can only pay debt service on the Refunding Bonds from the revenues generated by an ad valorem tax levied on all taxable property located within the Issuer (the Tax).

On the Issue Date, the Issuer had a debt service fund (the DSF) for the purpose of payment of debt service on all outstanding tax-exempt debt of the Issuer, including the Refunded Bonds. Of the total balance in the DSF on the Issue Date, $a was properly allocated to the Refunded Bonds. Of the portion of the DSF allocated to the Refunded Bonds, $b (the Current Portion) were revenues from the Tax that the Issuer would have used to pay the current debt service on the Refunded Bonds were they not being refunded by the Refunding Bonds. The remaining portion of the DSF allocable to the Refunded Bonds on the Issue Date was $c (the Reserve Portion), which the Issuer treated as a reserve fund for the Refunded Bonds.

The Issuer stated in the tax certificate for the Refunding Bonds that it would use the Current Portion to pay a portion of the debt service due on the Refunding Bonds on Date 1, the first debt service payment date on the Refunding Bonds, and that it would hold the Reserve Portion as a reserve for the Refunding Bonds. On Date 1, the Issuer paid debt service on the Refunding Bonds using funds from the DSF. After the payment, the portion of the DSF properly allocated to the Refunding Bonds, if reduced by the Reserve Portion and the maximum amount that would qualify as a bona fide debt service fund for the Refunding Bonds, would have been approximately equal to the Current Portion.

For both the Refunding Bonds and the Refunded Bonds, the annual debt service scheduled during Period 1 was notably lower than in the subsequent years. Two of the serial maturities of the Refunding Bonds were capital appreciation bonds maturing in the two years immediately following Period 1. The yield on the Refunding Bonds is d%, which is lower than the yield on the Refunded Bonds. Pursuant to arrangements for the advance refunding, the Issuer established a defeasance escrow, the earliest maturing investment in which had a yield of e%. Between the Issue Date and Date 1, amounts in the DSF were in invested at yields higher than e% but lower than d%.

LAW AND ANALYSIS:

Section 103(a) of the Code provides that, except as provided in § 103(b), gross income does not include interest on any State or local bond. Section 103(b) provides in part that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148). Section 148(a) provides that, for purposes of § 103, the term “arbitrage bond” means 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.

Section 1.148-10(a)(1) provides that bonds of an issue are arbitrage bonds under § 148 if an abusive arbitrage device under § 1.148-10(a)(2) is used in connection with the issue. It further provides that this paragraph (a) is to be applied and interpreted broadly to carry out the purposes of § 148, as further described in § 1.148–0. It also provides that, except as otherwise provided in § 1.148-10(c), any action that is expressly permitted by § 148 or §§ 1.148-1 through 1.148-11 is not an abusive arbitrage device (e.g., investment in higher yielding investments during a permitted temporary period under § 148(c)). Section 1.148-10(a)(2) provides that any action is an abusive arbitrage device if the action has the effect of (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and (ii) overburdening the tax-exempt bond market. Section 1.148-10(a)(3) provides that an action may exploit tax-exempt interest rates under § 1.148-10(a)(2) as a result of an investment of any portion of the gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

Section 1.148-10(d), example 3(i) provides the following example of a window refunding. Authority issues its 1994 refunding issue to refund a portion of the principal and interest on its outstanding 1985 issue. The 1994 refunding issue is structured using zero-coupon bonds that pay no interest or principal for the 5-year period following the issue date. The proceeds of the 1994 refunding issue are deposited in a refunding escrow to be used to pay only the interest requirements of the refunded portion of the 1985 issue. Authority enters into a guaranteed investment contract with a financial institution, G, under which G agrees to provide a guaranteed yield on revenues invested by Authority during the 5-year period following the issue date. The guaranteed investment contract has a yield that is no higher than the yield on the refunding issue. The revenues to be invested under this guaranteed investment contract consist of the amounts that Authority otherwise would have used to pay principal and interest on the 1994 refunding issue. The guaranteed investment contract is structured to generate receipts at times and in amounts sufficient to pay the principal and redemption requirements of the refunded portion of the 1985 issue. A principal purpose of these transactions is to avoid transferred proceeds. Authority will continue to invest the unspent proceeds of the 1985 issue that are on deposit in a refunding escrow for its 1982 issue at a yield equal to the yield on the 1985 issue and will not otherwise treat those unspent proceeds as transferred proceeds of the 1994 refunding issue. The 1994 refunding issue is an issue of arbitrage bonds since those bonds involve a transaction or series of transactions that overburdens the market by leaving bonds outstanding longer than is necessary to obtain a material financial advantage based on arbitrage. Specifically, Authority has structured the 1994 refunding issue to make available for the refunding of the 1985 issue replacement proceeds rather than proceeds so that the unspent proceeds of the 1985 issue will not become transferred proceeds of the 1994 refunding issue.

Section 1.148-10(d), example 3(ii)(B) provides that, in the following circumstances, the result would be the same as in example 3(i). The facts are the same as in example 3(i) except that there are no unspent proceeds of the 1985 issue and Authority invests the released revenues at a yield materially higher than the yield on the 1994 issue.

Section 1.148-10(c)(1) provides that, except as otherwise provided in § 1.148-10(c), an abusive arbitrage device is used and bonds of an advance refunding issue are arbitrage bonds if the issue has excess gross proceeds. Section 1.148-10(c)(2) provides that excess gross proceeds means all gross proceeds of an advance refunding issue that exceed an amount equal to 1 percent of sale proceeds of the issue, other than gross proceeds allocable to, among other things, a reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund and replacement proceeds in a sinking fund for the refunding issue.

Section 1.148-1(c)(1) provides that amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental

purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in § 1.148-1(c)(4), to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee. Section 1.148-1(c)(2) provides that sinking fund includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.

Section 149(d)(1) provides that nothing in § 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in paragraph (2), (3), or (4). Section 149(d)(4) provides that an issue is described in this paragraph if any bond (issued as part of such issue) is issued to advance refund another bond and a device is employed in connection with the issuance of such issue to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates. Section 1.149(d)-1(b) provides that an advance refunding issue employs an abusive device and is described in § 149(d)(4) if the issue violates any of the anti-abuse rules under § 1.148-10. The report of the Senate Committee on Finance regarding H.R. 3838, the Tax Reform Act of 1986, (the Senate Report) provides the following example of one of the types of transactions that are to be treated as devices for purposes of § 149(d)(4):

> Pursuant to a transaction or series of transactions in connection with the issuance of advance refunding bonds, proceeds of the refunding bonds are allocated to amounts used to pay debt service on the refunded bonds which, absent the refunding, would have been paid with proceeds (other than proceeds in a reasonably required reserve fund) of the prior issue. Assume, for example, that proceeds of the refunding bonds are allocated to amounts used to pay the next installment of debt service on the refunded bonds. Absent the refunding, the next installment of debt service would have been paid with revenues accumulated on or before the date of issue of the refunding bonds (or capitalized interest on the refunded bonds). The method of allocation adopted by the issuer permits the issuer to allocate the revenues to amounts used to pay a later installment of debt service on the refunded bonds and to invest the revenues and the earnings thereon substantially longer than they would have been invested absent the refunding. The allocation method is a device in that it enables the issuer to obtain a material financial advantage that would not have

> been available if proceeds of the refunding bonds had not been allocated to amounts used to pay debt service which otherwise would have been paid with the prior issue proceeds.

S. Rep. No. 99-313, at 850 (1986).

Issue 1

For the Refunding Bonds to be arbitrage bonds under § 1.148-10(a), some action must have had the effect of enabling the Issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage. We see no evidence of such exploitation. Between the Issue Date and Date 1 (the only time period for which facts were provided), the Issuer invested the Current Portion (the only amount discussed by the Service in connection with this issue) in the DSF and earned a yield on those investments that was lower than d%, the yield on the Refunding Bonds. The Issuer's investment of the Current Portion at a yield higher than e%, the yield on the earliest maturing investments in the defeasance escrow, did not enable it to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage.

Although the Refunding Bonds are comprised in small part of capital appreciation bonds, they do not resemble the impermissible window refunding described in § 1.148-10(d), ex. 3(ii)(B). The Issuer paid both principal and interest on the Refunding Bonds in each year during Period 1, the purported window. In addition, the debt service schedule on the Refunding Bonds appears to have been structured to match that on the Refunded Bonds. Although we have no information regarding the yield at which the issuer invested any other revenues from the Tax, it invested the Current Portion at a yield below that on the Refunding Bonds. While we do not conclude that refundings with different facts will never be window refundings of the sort described in § 1.148-10(d), ex. 3(ii)(B), we cannot conclude on the facts presented here that the Refunding Bonds are such a refunding.

On the facts presented, we see no other reason to conclude that the Issuer took some action to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage. We therefore conclude that no abusive arbitrage device, as defined in § 1.148-10(a), was used in connection with the Refunding Bonds. (We express no opinion regarding, and cannot determine based on the facts submitted, whether the Issuer's actions had the effect of overburdening the tax-exempt bond market.)

Issue 2

The Reserve Portion and the Current Portion are not excess gross proceeds under § 1.148-10(c) because both are replacement proceeds in sinking funds for the refunding issue. As defined in § 1.148-1(c), replacement proceeds include sinking funds, and

sinking funds include a debt service fund, a reserve fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue. Both the Current Portion and the Reserve Portion are held in sinking funds for the Refunding Bonds; the Current Portion is held in a debt service fund, the Reserve Portion is held in a reserve fund, and both amounts are reasonably expected to be used to pay principal or interest on the Refunding Bonds. Because the Current Portion and the Reserve Portion are held in sinking funds, they are replacement proceeds. (We express no opinion on whether the Reserve Portion is held in a reasonably required reserve or replacement fund.)

Issue 3

We see no device employed to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates, as described in § 149(d)(4). In the example in the Senate Report, proceeds of the refunding issue are allocated to amounts used to pay debt service on the refunded issue which, absent the refunding, would have been paid with replacement proceeds of the refunded issue. Likewise, in the refunding at issue here, the Issuer used proceeds of the Refunding Bonds held in the defeasance escrow to pay debt service on the Refunded Bonds which, absent the refunding, might have been paid with the Current Portion, an amount that was replacement proceeds of the Refunded Bonds. In the example in the Senate Report, however, the issuer's allocations permit it to invest the replacement proceeds of the refunded issue, which are eligible to be invested at the yield of the refunded issue, a yield presumably higher than that of the refunding issue, for a longer period than would have been possible if it had allocated those amounts to the earliest possible payment of debt service on the refunded issue. In the case at hand, however, the Current Portion was, according to the facts presented, invested at a yield lower than that on the Refunding Bonds. Thus, the Issuer has not obtained a material financial advantage of the kind described in the example in the Senate Report.

As stated in our analyses of Issues 1 and 2 above, we conclude that the facts demonstrate neither an abusive arbitrage device of the kind contemplated in § 1.148-10(a) nor excess gross proceeds under § 1.148-10(c). We find no evidence in the facts submitted of any other device employed in connection with the issuance of the Refunding Bonds to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates, as described in § 149(d)(4).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.