Office of Chief Counsel
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to: Area Counsel, PCLA
(TEGE Division Counsel)

from: Senior Technician Reviewer, Branch 5
(Financial Institutions & Products)

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subject: Deallocation of investments under the universal cap rules

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Bonds

Issuer

Issue Date

Date 2

a

b

c

d

e

f

ISSUE

Whether, for purposes of deallocating investments under the general ordering rule in § 1.148-6(b)(2)(iv) of the Income Tax Regulations, the qualified mortgage loans that were financed with transferred proceeds of the Bonds are investments allocable to replacement proceeds or are investments allocable to transferred proceeds.

CONCLUSION

The qualified mortgage loans financed with transferred proceeds of the Bonds are investments allocable to transferred proceeds for purposes of the universal cap ordering rule.

FACTS

The facts below have been provided by the examining agent.

On Issue Date, Issuer issued the Bonds as qualified mortgage bonds and used the proceeds of the Bonds to currently refund certain prior bonds (the "Prior Bonds"). Upon the refunding, proceeds of the Prior Bonds, including unspent sales proceeds and repayments of mortgages made with proceeds of the Prior Bonds, became transferred proceeds of the Bonds. The Issuer used transferred proceeds of the Bonds to fund a reserve fund for the Bonds (the "Reserve Fund") and to finance new mortgage loans.

As of Date 2, the value of the outstanding Bonds was $a, an amount less than the investments allocable to the Bonds. The values of investments allocable to the Bonds were as follows:

- Mortgage loans financed with transferred proceeds $b
- Mortgage loans financed with proceeds of other bonds $c
- Investment acquired with transferred proceeds in the Reserve Fund $d

- Investment acquired with investment proceeds In the Reserve Fund $<u>e</u>
- Total Investments allocable to the Bonds $<u>f</u>

As of Date 2, Issuer deallocated all of the mortgage loans financed with proceeds of other issues and a portion of the mortgage loans that were financed with transferred proceeds. Issuer did not deallocate any portion of the investment in the Reserve Fund.

The Issuer has filed Form 8038-R to request a refund of an overpayment of rebate.

<u>LAW AND ANALYSIS</u>

Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond which is issued as part of a qualified mortgage issue. Section 143(a)(2) provides that the term "qualified mortgage issue" means an issue by a State or political subdivision thereof of 1 or more bonds, but only if, among other requirements, such issue meets the requirements of § 143(g). Section 143(g)(1) provides, in pertinent part, that an issue meets the requirements of § 143(g) only if such issue meets the requirements of § 143(g)(2) (that the effective rate of mortgage interest not exceed the bond yield by more than 1.125 percentage points) in addition to the requirements 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 or are intentionally 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 148(f) provides that a bond is an arbitrage bond if an amount equal to certain investment earnings on nonpurpose investments in excess of the bond yield is not paid timely.

Section 1.148-6(b)(1) provides, in part, that amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are allocated to transferred proceeds of another issue, or cease to be allocated to that issue at retirement of the issue or under the universal cap of § 1.148-6(b)(2). Under § 1.148-6(b)(1), amounts that cease to be allocated to an issue as gross proceeds are eligible for allocation to another issue.

Section 1.148-6(b)(2)(ii) provides that, except as otherwise provided, amounts that would otherwise be gross proceeds allocable to an issue are allocated (and remain allocated) to the issue only to the extent that the value of the nonpurpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue. For this purpose, gross proceeds allocable to qualified mortgage loans, among other things, are treated as nonpurpose investments. The value of all outstanding bonds of the issue is referred to as the universal cap.

Section 1.148-6(b)(2)(iv)(A) provides that if the value of all nonpurpose investments allocated to the gross proceeds of an issue exceeds the universal cap for that issue on a date as of which the cap is determined under § 1.148-6(b)(2)(iii), nonpurpose investments allocable to gross proceeds necessary to eliminate that excess cease to be allocated to the issue, in the following order of priority--

(1) First, nonpurpose investments allocable to replacement proceeds;
(2) Second, nonpurpose investments allocable to transferred proceeds; and
(3) Third, nonpurpose investments allocable to sale proceeds and investment proceeds.

Section 1.148-6(b)(2)(iv)(C) provides that portions of investments to which the universal cap applies are allocated under either the ratable method or the representative method in the same manner as allocations of portions of investments to transferred proceeds under § 1.148-9(c).

Section 1.148-1(b) provides the following definitions:

“Gross proceeds” means any proceeds and replacement proceeds of an issue.

“Proceeds” means any sale proceeds, investment proceeds, and transferred proceeds of an issue. Proceeds do not include, however, amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under § 1.148-2(d) or § 143(g), or to qualified administrative costs recoverable under § 1.148-5(e).

Section 1.148-1(c) provides, in part, 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.

Section 1.148-6(d)(2)(ii) provides that if gross proceeds of an issue are allocated to a purpose investment that is a qualified mortgage loan or a qualified student loan, those gross proceeds are allocated to an expenditure for the governmental purpose of the issue on the date on which the issuer allocates gross proceeds to that purpose investment. Section 1.148-6(d)(2)(iii) provides that regardless of whether gross proceeds of a conduit financing issue invested in a purpose investment have been allocated to an expenditure under § 1.148-6(d)(2)(i) or (ii), with respect to the actual issuer those gross proceeds continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment.

As of Date 2, the value of the investments allocable to the Bonds exceeded the value of the outstanding Bonds, or universal cap. In deallocating investments, the Issuer deallocated all of the mortgage loans financed with proceeds of issues other than the Bonds, the amount of which was less than the value of the investments in excess of the universal cap. The Issuer deallocated the remaining amount of the excess (the "Remainder") solely from the mortgage loans financed with transferred proceeds of the Bonds and none from the investment in the Reserve Fund.

The Agent argues that the Remainder should have been deallocated using ratable portions of the investment of $d in the Reserve Fund and the mortgage loans financed with proceeds of the Bonds, because these investments were financed with, and therefore allocable to, transferred proceeds of the Bonds.

The Issuer argues that it properly deallocated the entire Remainder from the mortgage loans acquired with transferred proceeds of the Bonds because these mortgage loans should be treated as allocable to replacement proceeds. Specifically, the Issuer argues that once the transferred proceeds were spent on the mortgage loans, these mortgage loans should be treated as allocable to replacement proceeds because the repayments of these mortgage loans are pledged to the repayment of the Bonds, and these mortgage loans deallocated prior to the deallocation of any investments in the Reserve Fund.

For the following reasons, we agree with the Agent. In determining to which type of gross proceeds the investments are allocable, we look to the source of the financing for those investments. Both the mortgage loans financed with the Bonds and the $d of investments in the Reserve Fund were acquired with transferred proceeds, not replacement proceeds, of the Bonds. Under § 1.148-1(c)(1), amounts are replacement proceeds of an issue if such amounts would have been used for the governmental purpose of the issue if the proceeds of the issue were not so used. Here, the Issuer used proceeds, specifically transferred proceeds, of the Bonds to acquire these mortgage loans. Under § 1.148-6(d)(2)(iii), those proceeds of the Bonds continue to be allocated to the mortgage loans financed with the transferred proceeds and, under the facts of this case, those proceeds continue to be transferred proceeds. Thus, the loans are allocable to transferred proceeds. These mortgage loans are distinguishable from the mortgage loans financed with proceeds of other issues that have been allocated to the Bonds after being deallocated from those other issues.

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Please call (202) 317-6980 if you have any further questions.