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Internal Revenue Service  
Memorandum**

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from: Area Counsel (Pacific Coast Area)  
(Tax Exempt & Government Entities Division Counsel)

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subject: Mortgage bonds

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LEGEND

Bonds =  
Prior Bond 1 =  
Prior Bond 2 =  
Prior Bond 3 =  
Prior Bond 4 =  
Prior Bond 5 =  
Issuer =

Issue Date =  
Date 2 =  
Date 3 =  
Date 4 =  
Date 5 =  
a =  
b =  
c =  
d =  
e =

f =

### ISSUES

1. Whether the Issuer properly allocated repayments and prepayments from mortgages financed with certain other issues to the Bonds.
2. Whether the Issuer is in compliance with the general ordering rule in Treas. Reg. § 1.148-6(b)(2)(iv) for purposes of allocating proceeds under the universal cap.
3. Whether the Issuer's use of the proceeds that it allocated to the Bonds to purchase or make new mortgage loans is in compliance with the requirements of I.R.C. § 143(a)(2)(iv).
4. Whether I.R.C. § 146(a), which imposes requirements related to volume cap on private activity bonds, applies to the Bonds.

### CONCLUSIONS

1. Based on the facts currently contained in the case file, the Issuer's allocation of repayments and prepayments from mortgages financed with other issues to the Bonds does not cause the Bonds to be arbitrage bonds under I.R.C. § 148. We have included in our discussion below additional facts which may confirm whether or not there are any compliance issues with the Issuer's practice.
2. Because the amounts the Issuer deallocated under the universal cap were either replacement proceeds or transferred proceeds, the deallocation was in compliance with Treas. Reg. § 1.148-6(b)(2)(iv).
3. The information available indicates the Issuer is in compliance with the requirements of I.R.C. § 143(a)(2)(iv).
4. The requirements of I.R.C. § 146(a) do not apply to the Bonds because the exception in I.R.C. § 146(i)(1) is applicable.

### FACTS

On Issue Date, the Issuer issued the Bonds as qualified mortgage bonds under I.R.C. § 143. The maturity schedule included in the Official Statement provides that the Bonds mature on Date 2. The Issuer did not obtain a volume cap allocation for the Bonds within the meaning of I.R.C. § 146.

The Bonds were issued to pay at maturity all or a portion of Prior Bond 1, Prior Bond 2, Prior Bond 3, Prior Bond 4 and Prior Bond 5 (collectively, the "Refunded Bonds"), within 90 days of the issue date of the Bonds. Specifically, the Bonds paid at maturity or refunded the following bonds in amounts totaling \$a:

Prior Bond 1	\$ <u>b</u>
Prior Bond 2	\$ <u>c</u>
Prior Bond 3	\$ <u>d</u>
Prior Bond 4	\$ <u>e</u>
Prior Bond 5	\$ <u>f</u>

The Issuer then treated repayments and prepayments in an amount totaling \$a from mortgage loans financed by the Refunded Bonds and certain other issues as proceeds allocable to the Bonds. These repayments and prepayments were held in a reserve fund and program fund.

For purposes of Treas. Reg. § 1.148-6(b)(2), commonly referred to as the universal cap, the Issuer submitted information indicating that it treated the repayments and prepayments it allocated to the Bonds as transferred proceeds. On the issue date of the Bonds, the nonpurpose investments allocable to the gross proceeds of the Bonds - including amounts held in the program fund, reserve fund, and a refunding escrow - exceeded the universal cap (value of all outstanding bonds of the issue) by the amount of prepayments and repayments allocated to the Bonds from other issues. The Issuer eliminated the excess by deallocating the amounts that it treated as transferred proceeds.

On Date 3, the Issuer expended the proceeds held in the refunding escrow to redeem the Refunded Bonds. As such, the Bonds had unused universal cap in an amount equal to the amount used to redeem the Refunded Bonds. The Issuer reallocated to the Bonds amounts held in the reserve fund and program fund, such that the value of the nonpurpose investments allocated to the Bonds equaled the value of the Bonds.

The Issuer stated that the repayments and prepayments from mortgage loans made from other issues, including the Refunded Bonds, that it allocated to the Bonds were not required to be used to refund any bond pursuant to the rule in I.R.C. § 143(a)(2)(A)(iv), commonly referred to as the "10-year rule." According to the Issuer, these repayments and prepayments were either received prior to the applicable 10 year date under I.R.C. § 143(a)(2)(A)(iv), or were from mortgages financed by bonds that were no longer outstanding.

The Issuer described its compliance with the requirements of the 10-year rule in I.R.C. § 143(a)(2)(A)(iv) as follows. Generally the Issuer tracks mortgages by reference to the issue date of the original issue from which the mortgage originated, and after 10 years, uses prepayments to redeem bonds in the original issue unless the original issue is no longer outstanding. If the original issue has been partially refunded, the Issuer will use prepayments from mortgages transferred to the refunding issue to redeem bonds of the refunding issue if the prepayments are received more than 10 years after the issue date of the original issue. If the refunding issue is partially refunded, the Issuer uses the issue date of the original issue to determine the timing and amount of repayments and prepayments that must be used to redeem amounts of the second refunding bond. If the original bond has been refunded by a second refunding issue in a recycling of

prepayments, the Issuer uses prepayments from mortgages originated by that refunding issue to redeem bonds of that refunding issue if the prepayments are received more than 10 years after the issue date of the original issue, even though mortgages are originated with repayments and prepayments previously allocated to issues other than the Refunded Bonds.

The Issuer submitted documents to show how it implemented this policy for purposes of the Bonds. The Issuer determined the proportion of Bond proceeds used to redeem each of the Refunded Bonds. Each of the Refunded Bonds was itself issued to refund other issues. Thus, the Issuer determined the proportion of the Bond proceeds attributable to each issue refunded by a Refunded Bond. The Issuer continued to trace the refunding issues in each series of refundings until it identified all 'new money issues' (referred to as original bonds in I.R.C. § 143) and the proportion of the Bond proceeds attributable to each. The Issuer's records show the issue dates of the original bonds date as far back as Date 4. The Issuer then determined the 10-year rule date for each original issue. When the Issuer receives a prepayment or repayment on a mortgage loan made with proceeds of the Bonds, the Issuer is able to determine the proportion of the prepayment or repayment that must be used to redeem the appropriate portion of the Bonds.

### LAW AND ANALYSIS

1. Whether repayments and prepayments from mortgages financed with other issues were properly allocated to the Bonds.

I.R.C. § 143(a)(1) provides that the term "qualified mortgage bond" means a bond which is issued as part of a qualified mortgage issue. I.R.C. § 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 I.R.C. § 143(g). I.R.C. § 143(g)(1) provides, in pertinent part, that an issue meets the requirements of I.R.C. § 143(g) only if such issue meets the requirements of I.R.C. § 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 I.R.C. § 148.

I.R.C. § 148(a) provides that, for purposes of I.R.C. § 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. Treas. Reg. § 1.148-0(b) provides that Treas. Reg. §§ 1.148-1 through 1.148-11 apply generally for purposes of the arbitrage restrictions under I.R.C. § 148.

Treas. Reg. § 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 Treas. Reg. § 1.148-6(b)(2). Under Treas. Reg. § 1.148-6(b)(1), amounts that cease to be allocated to an issue as gross proceeds are eligible for allocation to another issue.

Treas. Reg. § 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.

Treas. Reg. § 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.

Treas. Reg. § 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. Treas. Reg. § 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 Treas. Reg. § 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.

Treas. Reg. § 1.148-9 contains special arbitrage rules for refunding issues. Treas. Reg. § 1.148-9(b)(1) provides, in part, that when proceeds of the refunding issue discharge any of the outstanding principal amounts of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is an amount equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction, (i) the numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge, and (ii) the denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of the discharge. Treas. Reg. § 1.148-9(c)(1) provides rules for allocating investments purchased with sale proceeds or investment proceeds of a refunding issue. Treas. Reg. § 1.148-9(c)(1)(ii) provides the allocation method that must be used when proceeds of a prior issue become transferred proceeds of a refunding issue, depending on whether investments (and the related payments and receipts) of proceeds of the prior issue are held in a refunding escrow for another issue.

In the present case, the Issuer treated repayments and prepayments of mortgage loans made with the Refunded Bonds and other bond issues as transferred proceeds

allocated to the Bonds. The amount of repayments and prepayments treated by the Issuer as transferred proceeds allocated to the Bonds equaled the amount of the Bonds. Additionally, the Bond's sale proceeds were used to pay at maturity or refund the Refunded Bonds. In accordance with the rules of Treas. Reg. § 1.148-9(b)(1), proceeds of the Refunded Bonds that ceased to be proceeds of the Refunded Bonds were allocated to the Bonds as transferred proceeds.

We do not have enough information to determine what portion of the amounts the Issuer treated as transferred proceeds allocated to the Bonds were transferred proceeds within the meaning of the applicable regulations. Nevertheless, because the Issuer provided that the amounts were used to make new mortgage loans under the Bonds, the amounts appear to have a sufficiently direct nexus to the governmental purpose of the Bonds to conclude that, if not transferred proceeds, they were replacement proceeds of the Bonds under Treas. Reg. § 1.148-1(c). Thus, based on the information available the Issuer's allocation of these amounts to the Bonds does not violate the arbitrage restrictions under I.R.C. § 148.

We note, however, that there are issues with respect to which we did not have enough information to determine whether there could be compliance concerns. We include a brief discussion of these areas for Exam's consideration. First, although above we conclude that the Issuer's allocation of amounts to the Bonds did not cause the Bonds to be arbitrage bonds under I.R.C. § 148, the file did not contain sufficient information to determine whether these amounts were properly deallocated from the issues from which they originated. In accordance with Treas. Reg. § 1.148-6(b)(1) an amount would need to have ceased to be allocated to the issue from which it originated in order for the amount to be eligible for allocation to another issue. However, since to the extent there is a compliance concern it would be with respect to the issue from which it originated (as opposed to the Bonds), we understand this may be outside the scope of the current examination.

Additionally, although above we conclude that any amount allocated to the Bonds pursuant to Treas. Reg. § 1.148-9(b)(1) would be allocated as transferred proceeds, the file did not include sufficient information to determine whether the requirements of Treas. Reg. § 1.148-9 were satisfied. In particular, Treas. Reg. § 1.148-9(b)(1) provides rules to determine the amount of proceeds of the refunded issue that become proceeds of the refunding issue. Additionally, Treas. Reg. § 1.148-9(c)(1) provides rules regarding the allowable allocation methods for the investments corresponding to those transferred proceeds. The amount or proceeds and the investments allocated to the Bonds must be in compliance with these requirements in order for the allocation as transferred proceeds to be correct.

2. Whether the Issuer is in compliance with the general ordering rule in Treas. Reg. § 1.148-6(b)(2)(iv) for purposes of allocating proceeds under the universal cap.

Treas. Reg. § 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.

Treas. Reg. § 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 Treas. Reg. § 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.

Treas. Reg. § 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 Treas. Reg. § 1.148-9(c).

In the present case, on the issue date the nonpurpose investments of the Bonds exceeded the value of the Bonds. The Issuer eliminated the excess by deallocating the prepayments and repayments from other issues that it considered to be transferred proceeds.<sup>1</sup> As explained above in our discussion of Issue 1, to the extent the Issuer incorrectly deemed any amount to be transferred proceeds of the Bonds, the amounts would have been replacement proceeds of the Bonds. Therefore, the result of the Issuer's deallocation complied with the ordering rules under Treas. Reg. § 1.148-6(b)(2)(iii) because all nonpurpose investments allocable to replacement proceeds and transferred proceeds were deallocated.

On Date 3, the Issuer expended the Bond proceeds to redeem the Refunded Bonds. It then reallocated to the Bonds the prepayments and repayments from other issues that it had deallocated on application of the universal cap on the issue date. Thereafter, the value of the nonpurpose investments allocated to the Bonds equaled the value of the

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<sup>1</sup> It does not appear that the Issuer was required to determine and apply the universal cap on this date pursuant to the rules of Treas. Reg. § 1.148-6(b)(2)(iii). Further, pursuant to Treas. Reg. § 1.148-9(b)(1), transferred proceeds do not arise until the date on which proceeds of the refunding issue discharge the outstanding principal amount of the prior issue.

Bonds. Accordingly, under the facts provided the results of the Issuer's allocations were in compliance with Treas. Reg. § 1.148-6(b)(2)(iv).

We note that under different facts, if the Issuer incorrectly deemed amounts to be transferred proceeds when they were replacement proceeds, there is a substantial risk that the requirements of Treas. Reg. § 1.148-6(b) would not be met. Exam may wish to follow up with the Issuer in order to ensure future compliance concerns are avoided.

3. Whether the Issuer's use of the proceeds that it allocated to the Bonds to purchase or make new mortgage loans is in compliance with the requirements of I.R.C. § 143(a)(2)(iv).

Among other requirements, pursuant to I.R.C. § 143(a)(2)(A)(iv) an issue is a qualified mortgage issue only if repayments of principal on financing provided by the issue are used not later than the close of the 1st semiannual period beginning after the date of the prepayment (or complete repayment) is received to redeem bonds which are part of such issue. However, the flush language following I.R.C. § 143(a)(2)(A) provides that the requirement of I.R.C. § 143(a)(2)(A)(iv) shall not apply to amounts received within 10 years after the date of issuance of the issue (or, in the case of refunding bond, the date of the issuance of the original bond).

In the present case, the Issuer has represented that the repayments and prepayments from other issues that were used to make new mortgage loans under the Bonds were either received prior to the applicable 10 year date under I.R.C. § 143(a)(2)(A)(iv), or were from mortgages financed by bonds that are no longer outstanding. The information submitted by the Issuer appears to confirm that it is using prepayments and repayments it receives in a manner that does not violate the requirements of I.R.C. § 143(a)(2)(A), and Exam has not provided any information to suggest the Issuer is not following its practices as described in its submissions. Accordingly, the information available indicates the Issuer is in compliance with the requirements of I.R.C. § 143(a)(2)(iv).

4. Whether I.R.C. § 146(a), which imposes requirements related to volume cap on private activity bonds, applies to the Bonds.

I.R.C. § 103(a) provides that, in general, gross income does not include interest on any state or local bond. I.R.C. § 103(b)(1) provides that this exclusion shall not apply to any private activity bond which is not a qualified bond (within the meaning of I.R.C. § 141). I.R.C. § 141(e) provides, in part, that the term "qualified bond" means any private activity bond if such bond is a qualified mortgage bond and is issued as part of an issue which meets the applicable requirements of I.R.C. § 146.

I.R.C. § 146(a) provides that a private activity bond issued as part of an issue meets the requirements of this section if the aggregate face amount of the private activity bonds issued pursuant to such issue, when added to the aggregate face amount of tax-exempt private activity bonds previously issued by the issuing authority during the calendar year, does not exceed such authority's volume cap for such calendar year.

I.R.C. § 146(i) provides that, for purposes of the volume cap imposed by I.R.C. § 146, the term "private activity bond" shall not include any bond which is issued to refund another bond to the extent that the amount of such bond does not exceed the outstanding amount of the refunded bond. I.R.C. § 146(i)(3) provides that in the case of any qualified mortgage bond, I.R.C. § 146(i)(1) shall apply only if the maturity date of the refunding bond is not later than the later of (A) the average maturity date of the qualified mortgage bonds to be refunded by the issue of which the refunding bond is a part, or (B) the date 32 years after the date on which the refunded bond was issued (or in the case of a series of refundings, the date on which the original bond was issued).

In this case, the Bonds were issued to refund the Refunded Bonds. The fact that the Issuer made new mortgage loans under the Bonds does not affect the application of the rules of I.R.C. § 146. The amount of the Bonds did not exceed the outstanding amount of the Refunded Bonds. Thus, I.R.C. § 146(i)(1) applies and volume cap is not required for the Bonds so long as the provisions of I.R.C. § 146(i)(3) are satisfied.

The maturity date of the Bonds is Date 2. We do not have information relevant to determining the average maturity date of the bonds that were refunded by the issue of which the Bonds were a part. However, pursuant to I.R.C. § 146(i)(3)(B), because the Bonds are part of multiple series of refundings, I.R.C. § 146(i) will apply if the maturity date of the Bonds is not later than 32 years after the issue date of the original bond. In other words, if the oldest bond in the series of refundings was issued no earlier than Date 5, the provisions of I.R.C. § 143(i)(3) are satisfied and the Bonds do not require volume cap. Here, the oldest bonds which we are aware of being part of this series of refundings originated on Date 4. Therefore, the Bonds satisfy I.R.C. § 146(i)(3)(B) and the rule under I.R.C. § 146(i) excluding refunding bonds from volume cap requirements applies.

**CONCLUSION**

If you have any further questions or concerns, please contact Michelle Weigelt at (206) 946-3584.

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