Internal Revenue Service

Department of the Treasury

Number: **200046021**
Release Date: 11/17/2000
Index Numbers: 148.00-00, 148.02-01

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:TEGE:EOEG:TEB-PLR-104013-00
Date:
August 18, 2000

In Re:

Legend

District =

Bonds =

State =

Retirement System =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

Year 9 =

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Dear :

This letter is in response to your request on behalf of the District for a ruling that interest on the Bonds will be excluded from income under § 103 of the Internal Revenue Code (the "Code"). Pursuant to § 7478 and Rev. Proc. 96-16, 1996-1 C.B. 630, our private letter ruling is one subject to review under the declaratory judgment provisions of § 7478.

Facts

A. Overview of the Retirement System

The District is a political subdivision of the State and is a participating employer in the Retirement System. The Retirement System is a cost-sharing, multiple employer retirement system established and administered by the State to provide pension benefits for State and local government employees. Participating employers include State agencies, counties, cities, State colleges, and public school districts. The Retirement System operates as a defined benefit plan, which means that the amount of the retirement benefits to be paid to an employee is determined in advance of the employee's retirement based on factors such as length of service and salary. The amount of the benefits is not tied to investment performance of contributions on an

employee’s behalf. As will be discussed in more detail below, the employers’ contributions are determined by actuarial calculations.

The Retirement System uses the actuarial valuation method known as the frozen initial liability actuarial method. Under this method, participating employers make two types of required contributions. These are called “prior service contributions” and “current service contributions.” Prior service contributions are expected to fund the prior service liability, which is the cost of future pension benefits payable from employer contributions that are assigned to years of service prior to the date of the establishment of the prior service liability. Current service contributions fund the cost of future pension benefits payable from employer contributions assigned to the years of service after the establishment of the prior service liability, with adjustments to reflect actuarial gains and losses arising from the difference between actual and assumed experience with respect to all benefits. How these amounts were determined for the Retirement System is discussed in further detail below.

The Retirement System has several accounts and reserves, including the employer reserve, the employee reserve and the annuitant reserve. The employer reserve is credited with all required employer contributions, including interest on the prior service liability, and any employer's advance payment of a prior service liability. Cite 1. The employee reserve is credited with contributions made by participating employees. Cite 2. Once an employee is eligible to retire, moneys are transferred from the employer reserve and the employee reserve to an annuitant reserve in amounts estimated to be sufficient to fund the annuity to be paid to that employee. Cites 1, 2, 3.

Amounts credited to the these three reserves are pooled and invested. Those investments include securities and obligations. Investment earnings are credited to the reserves after deducting administrative costs. Cite 4. Investment earnings are those earnings, and profits or losses required to be distributed among the reserves of the Retirement System. This includes 100 percent of all current income and a percentage of the accumulated gains or losses from the sale of investments. Cite 5. The net investment earnings when computed as a rate of return on investments is referred to as the annual investment return.

The annuitant reserve receives the annual investment return on the money credited to that reserve. Cite 3. Contributions to the employee reserve after Date 2 receive a return of a percent. The employer reserve is credited with the remaining investment earnings. Historically, the return credited to money in the employer reserve exceeded the annual investment return. The Board does not have discretion over the amount of investment return to be credited to reserves or how the investment return is to be credited. Cite 5.

During the last 17 years ending in Year 9, the annual investment returns have ranged from a low of b percent to a high of c percent. In Year 8, the Retirement System

held approximately $d in investments to pay retirement benefits. In the 17 years ending in Year 9, the highest amount that the System has had to pay in pension benefits in any year was approximately $e.

B. History of the Retirement System

Prior to Date 1, the State sponsored three pension systems. The District's employees were covered under two of these systems, one for the teachers and one for the non-teachers. The District was required to participate in the teacher system, whereas it elected through an irrevocable election to participate in the system for its non-teachers. The District has never sponsored a pension system of its own; the State systems are the only ones that have provided pension benefits to its employees.

The District had an unfunded pension liability to each of the pension systems in which it participated. The amount of the unfunded pension liability was determined differently for the two plans. The non-teacher system used actual service of the covered employees in determining the pension liability. The teacher system used a cost-sharing method, which allocated the pooled prior service liability for all teachers to the participating employers based on their relative payrolls.

Effective Date 1, the State enacted legislation (the "Legislation") to merge its three existing pension systems to create the Retirement System. The Legislation also improved employee pension benefits. These improvements applied retroactively, which means for our purposes, that the improvements applied to pension benefits earned before Date 1. Through the Legislation, a prior service liability was calculated for each participating employer.

C. Employer contributions

Pursuant to the Legislation, participating employers are required to make two types of payments to the Retirement System--prior service contributions and current service contributions. If an employer fails to pay its contributions, the Retirement System can intercept any amounts due from State funds otherwise payable to the employer. In addition, if a participating employer ceases to exist, the employer that assumes responsibility for the functions of the prior employer is liable for the contributions that would have been payable by the predecessor employer.

1. Prior service liability

The Date 1 prior service liability was the estimated amount as of Date 1 needed to pay unfunded benefits payable from employer contributions earned by employees prior to Date 1. For employers who had participated in the predecessor systems, the prior service liability, in part, was calculated based on a combination of the approaches that had been taken by the predecessor systems. Additional unfunded liability resulting

from the benefit improvements provided by the Legislation was allocated to the participating employers' prior service liabilities based on relative payroll of each employer.

The Legislation mandated that contributions be made by each participating employer in amounts sufficient to amortize its prior service liability as a level percent of payroll over a period of f years. In computing the contribution rates, estimates of payroll were used. Because these contributions are a percentage of payroll, the Date 1 prior service liability might not be amortized over f years if payroll is less than anticipated. But employers must continue to make prior service contributions until their prior service liability is paid, even if beyond the amortization period. However, an employer is permitted to make advance contributions to reduce its prior service liability.

Interest is added to the prior service liability at the assumed rate. The assumed rate is an expected long-term average annual investment return set by the board of the Retirement System (the "Board"). Cite 6.

The District's prior service liability is described in further detail below.

2. Current service contributions

Participating employers are also required to make current service contributions, which are deposited into the employer reserve. These contributions are a percentage of the earnings of participating employees determined as though all employees of all participating employers are employees of a single employer. The employers' current service contribution rates are set annually by the Board. These rates are based on the information available at the time and on the assumptions recommended by the actuary but subject to the Board's approval, using the following formula:

$$\frac{\text{PV (Future benefits to be paid to employees of all participating employers) - Employer reserve - PV(Expected prior service liability contributions)}}{\text{PV(Expected future compensation)}}$$

where PV = present value. Cite 7.

The assumed rate is used in calculating present value. Cite 8.

D. Modifications to the prior service liability and contribution rates

On several occasions since the plans were merged, the State legislature has enacted amendments to the Legislation retroactively enhancing pension benefits. The District was aware that the State legislature has the authority to make changes in the benefits. Each of these improvements resulted in an increase to the District's prior

service liability and could increase current service contributions, depending on changes in actuarial assumptions.

The first of these amendments was effective in Year 2. That amendment recalculated the prior service liability using then-current actuarial assumptions and reamortized that liability over a new and longer amortization period of g years beginning on Date 3. Cite 9. In Year 3, the State legislature again retroactively enhanced benefits. Cite 10.

On one occasion, in Year 3, the State legislature reduced the prior service liability through the transfer of certain funds within the pension trust. Cite 11. That amendment also provided for a recalculation of the prior service liability and a new amortization period beginning Date 4.

In Years 4, 5, and 6, the Board adjusted employers' prior service liabilities on a system-wide basis due to changes in the actuarial assumptions used to calculate the prior service liabilities. Each of these adjustments reduced the prior service liability. The adjustments made by the Board were questioned, resulting in the State's Attorney General's opining in Year 9, that the Retirement System lacked authority to make these adjustments. While this matter has not been resolved, the District does not believe that the Years 4, 5, and 6 adjustments will be reversed.

The Board has also adjusted the assumed rate. At the time of the merger, Date 1, the assumed rate was set at h percent. In Year 4, the rate was increased to i percent, and in Year 5, it was increased to j percent. The assumed rate has always exceeded k percent by more than one-eighth of one percent.

E. The District's Prior Service Liability

As noted above, on Date 1, the Legislation caused a recalculation of the District's prior service liability. That liability was calculated to be $l. The District anticipated that it would pay the Date 1 liability over f years. That liability, however, substantially increased over time. The District's prior service liability increased with benefit improvements (and, to a lesser extent, decreased due to credits) as follows.

Year	Increases	Decreases
Year 2	$m	
Year 3	n	
Year 4		$p
Year 5		q
Year 6		r

Also, while the District made regular contributions to its prior service liability, the amount of interest added each year to the District's prior service liability balance exceeded the District's contributions. The District anticipated that it would make up for the shortfall in its payments in later years because it expected that its payroll would increase. Accordingly, the District's prior service liability in Year 9, was $s.

For financial accounting purposes, the District included its prior service liability as a long-term obligation on its financial statements.

In Year 7, the District resolved to make an advance payment for its prior service liability by paying the then current balance. The District, however, did not make the advance payment until Year 9. While the stated balance was then $s, the District only paid $t, an amount that is less than $s. The difference between $s and $t is interest that the Retirement System waived for Years 7 and 8. These waivers were given because of the uncertainty surrounding whether the Board had authority to adjust the prior service liability. More specifically, the Year 7 waiver was given because the District was delayed in making its advance payment due to the uncertainty of the credits. The Year 8 interest was waived because the Retirement System delayed the date by which full payment of the prior service liability could be made without accruing interest for the year until into Year 9, after the date that the District made its advance payment, again due to the uncertainty involving the credits.

The District issued short-term taxable obligations (the "taxable notes") and within 90 days used the proceeds to make its advance payment. A few months thereafter, the District refunded within 90 days the taxable notes with taxable bonds (the "taxable bonds").

The District made the advance payment for several reasons, including to reduce debt service costs and to free up money for other expenditures. Payments to the Retirement System are subject to the District's revenue cap on expenditures. Payments on debt service are not counted towards that cap.

F. The Proposed Bonds

On March 20, 2000, the school board of the District passed a resolution authorizing issuance of the Bonds. The District proposes to refund its taxable bonds with the Bonds. The District makes the following representations with respect to the Bonds:

1) the proceeds of the Bonds will be used to refund the taxable bonds within 90 days of issuance;

2) the yield on the Bonds is expected to be approximately k percent;

3) the Bonds will be issued in registered form;

4) the Bonds will not be federally guaranteed; and

5) the Bonds will meet the reporting requirements in § 149(e).

Based on the representations made by the District, the Bonds will not be private activity bonds. In addition, the Bonds will meet the applicable requirements of § 149, other than § 149(g), which we discuss below.

The central issue in this case is whether the Bonds will be arbitrage bonds under § 148.

Law

A. General Arbitrage Rules

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that subsection (a) shall not apply to any arbitrage bond (within the meaning of § 148).

Section 148 provides two tests for determining whether a bond is an arbitrage bond, § 148(a) and § 148(f). Section 148(f) generally provides that a bond is an arbitrage bond unless the issuer timely rebates to the United States the excess of the amount earned on certain nonpurpose investments over the amount that would be earned on those investments had those investments had a yield equal to the bond yield, plus any income attributable to the excess. Because § 148(f) applies to facts that arise after the bonds are issued, this letter ruling does not address the application of § 148(f).

Under § 148(a), an arbitrage bond is,

> 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 this subsection, 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 paragraph (1) or (2).

Proceeds include not only the proceeds from the sale of the bonds, but also generally include investment proceeds and transferred proceeds. § 1.148-1(b), Income Tax Regulations. Transferred proceeds can arise when bonds are issued to refund prior bonds, as discussed further below.

A "higher yielding investment" is "any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue." § 148(b)(1). "Materially higher" generally means one-eighth of 1 percentage point. § 1.148-2(d)(2)(i). Investment property includes (A) any security (within the meaning of § 165(g)(2)(A) or (B)), (B) any obligation, (C) any annuity contract and (D) any investment-type property. § 148(b)(2).

Investment-type property includes any property (other than property defined in § 148(b)(2)(A), (B), (C), or (E)) that is held principally as a passive vehicle for the production of income. Production of income includes any benefit based on the time value of money, including the benefit from making a prepayment. § 1.148-1(e)(1).

Investment-type property was added to the Code in 1986, when Congress expanded the application of the arbitrage rules. The legislative history makes clear that investment-type property was intended to include any annuity or deferred payment contract. Specifically, the Conference Report provides,

> The conference agreement follows the House bill and the Senate amendment in providing additional restrictions on the types of obligations in which bond proceeds may be invested without regard to yield restrictions. Under the conference agreement, therefore, the arbitrage restrictions are expanded to apply to the acquisition of any property held for investment other than another bond exempt from tax under Code section 103. Thus, investment in any taxable security as well as any deferred payment contract (e.g., an annuity) or other property held for investment is precluded if the yield on the property is materially higher than the yield on the issue.

H.R. Conf. Rep. No. 99-841, at II-747 (1986); 1986-3 C.B. (Vol. 4) 747 (footnote omitted). Even more specific to this case is the statement in the Conference Report describing the House Bill,

> ... Additionally, the House bill provides that investment property includes investment in deferred compensation arrangements. Thus, investment in annuity contracts to fund pension obligations are subject to the arbitrage

> restrictions in the same manner as if bond proceeds were deposited directly in the pension fund.

Id. at 745. The House Report also provides that "investment of bond proceeds in any other type of deferred payment investment-type contract to fund an obligation of the issuer or bond beneficiary would be subject to [the arbitrage rules]." H.R. Rep. No. 99-426, at 552 (1985), 1986-3 C.B. (Vol. 2) 552.

In expanding the definition of investment property, Congress was concerned about issuers avoiding the arbitrage rules through the use of deferred payment contracts. The House Report states:

> Finally, the committee has learned that a few governments have issued bonds in order to purchase annuity contracts from insurance companies. The purpose of these transactions is to fund unfunded liabilities of public employee pension plans. In essence, these transactions produce arbitrage profits which would not be allowed if bond proceeds were invested directly by the issuing government. In view of the substantial amount of unfunded pension liabilities of State and local governments and because there has been no explicit Congressional decision to assume responsibility for those liabilities, the bill prohibits the issuance of bonds for such a purposes.

H. R. Rep. No. 99-426, at 518 (1985), 1986-3 C.B. (Vol. 2) 518. *See also* S. Rep. No. 99-313, at 828 (1986), 1986-3 C.B. (Vol 3) 828.

When proceeds of an issue are used for the governmental purpose for which they were issued, they cease to be allocated to the bond issue. § 1.148-6(b)(1). In other words, the proceeds are no longer subject to the arbitrage rules.

<u>B. Arbitrage Rules for Refunding Bonds</u>

A refunding issue generally means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption on another issue (a prior issue). § 1.150-1(d). A prior issue generally means an issue of obligations all or a portion of the principal and interest on which is paid or provided for with proceeds of the refunding issue. § 1.150-1(d)(5). Obligation means any valid evidence of indebtedness under general Federal income tax principles. § 1.150-1(b). Thus, there can be no refunding issue unless the prior issue is a debt under general Federal income tax principles.

When proceeds of a refunding issue are allocated (used) to pay the principal and interest of the prior issue, those proceeds are spent for the governmental purpose and, accordingly, are not subject to the arbitrage rules. But "when proceeds of the refunding issue discharge any of the outstanding principal amount 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." § 1.148-9(b).

Analysis

A. Refunding Bonds

The District asserts that the prior service liability on Date 1 was a debt. The District further asserts that any increases to the prior service liability by legislative enactments date back to Date 1. Alternatively, the District asserts that the increases to the prior service liability were additional debts. Thus, the District argues that the Bonds will refund the taxable bonds, the taxable bonds were used to refund the taxable notes, and the taxable notes refunded the prior service liability, including the additional debts, if the alternative assertion applies.

While we accept the District's representation that the Bonds will be used to refund the taxable bonds and that the taxable bonds were used to refund the taxable notes, we disagree that the taxable notes were refunding bonds as we conclude that the prior service liability was not a prior issue because it was not an obligation.

Section 1.150-1(b) defines obligation as any valid evidence of indebtedness under general Federal income tax principles. Because neither the Code nor the regulations define indebtedness for general income tax purposes, we look to case law.

As a preliminary matter, it is important to note the distinction between debts and liabilities. Although a debt is a liability, not all liabilities are debts. *See Deputy v. du Pont*, 308 U.S. 488, 497 (1940). "Liability" is a broad legal term that has been defined as all character of debts, obligations and responsibilities; an obligation which may or may not ripen into a debt; any kind of debt or liability, either absolute or contingent, express or implied; and as a duty to pay money or perform some other service. Black's Law Dictionary 914 (6th ed. 1990).

Debt has been defined as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957). Whether a debt exists has been considered in a number of contexts. For example, under § 166, a debt arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. § 1.166-1(c). Generally, however, whether something is a debt is based on all the facts and circumstances, with no one factor controlling. *Fin Hay Realty v. United States*, 398 F.2d 694, 696-697 (3d Cir. 1968); *Dixie Dairies v. Commissioner*, 74 T.C. 476, 493 (1980).

The District has not cited, nor have we found, any cases in which a court under facts similar to those presented here determined whether a debt existed. The District cites *City of Columbus v. Commissioner*, 112 F.3d 1201 (D.C. Cir. 1997), rev'g. and remanding 106 T.C. 325 (1996), on remand T.C. Memo. 1998-135, in support of its position that the prior service liability is a debt. In that case, prepayment of an unfunded pension liability was held not to be investment-type property. While the Court of Appeals for the District of Columbia Circuit stated in dicta that the pension liability seemed to be an obligation of a State or political subdivision, the issue of whether or not the unfunded pension liability was an obligation was not before the court. *See id.,* 112 F.3d at 1206.

Moreover, the facts presented to the court in *City of Columbus* are very different than the facts presented here. *See* 106 T.C. at 326-327. The critical difference is that in *City of Columbus*, the unfunded prior service liability was separate and independent from the liability for current contributions. There, the State assumed Columbus' unfunded pension liability that arose prior to 1967. The State computed an estimate of that assumed liability using actuarial assumptions and required that Columbus pay that amount, with interest if the liability was paid over time. The State also required that Columbus pay for pension liabilities arising after 1967 through current contributions. The Tax Court found that Columbus was never obligated to make up for shortfalls or deviations from the actuarial calculation of the unfunded pension liability. The Tax Court also found that when Columbus prepaid its unfunded pension liability, it extinguished that liability. Finally, it does not appear that investment earnings on moneys held by the fund benefitted Columbus. The Tax Court found that the investment return benefitted the employees.

Here, the prior service liability is not separate from the liability for current contributions. While, like *City of Columbus*, the Date 1 prior service liability reflected an estimate of pension liabilities arising before Date 1 based on actuarial assumptions, unlike *City of Columbus*, corrections for shortfalls and deviations from the actuarial assumptions are passed on to the participating employers. As noted above, current contributions are based, in part, on the total expected pension benefits to be paid minus the amount that is expected to be paid through prior service contributions. The Board regularly updates the actuarial assumptions in determining current contribution rates. Thus, if an assumption used to determine the prior service liability proves incorrect, for example, if the average expected life of pensioners proves longer than estimated on Date 1, current contributions will correct the error. Further, as discussed below, investment return on the Retirement System's investments benefits participating employers.

The District also calls our attention to *Jamison v. United States*, 297 F. Supp. 221 (N.D. Cal. 1968). In *Jamison*, the taxpayers purchased the rights of a contractor to receive repayment of an advance the contractor had made to a utility. The contractor was to be repaid through a specified percentage of the utility's revenue over a specified

period of years. The total payments were not to exceed the advance, and if the agreed period of years expired prior to full repayment, the utility had no liability to make further payments. The issue was whether the contracts containing these rights were "other evidences of indebtedness" under former § 1232(a) (repealed by Pub. L. No. 98-369, § 42(a)(1)), so that amounts received by the taxpayers were capital gains.

The court noted that one aspect of the transaction was that the repayments from the utility were to be made from revenues, giving the transaction the appearance of equity rather than indebtedness. However, the court then noted that the purpose of § 1232(a) was to treat debt held as capital assets on par with securities held as capital assets. Accordingly, the court refused to apply a definition of indebtedness that was so narrow as to exclude the payments in question. Because we find that the court interpreted debt broadly to satisfy the purpose of § 1232(a) and because, as we discuss in further detail below, we find that the Retirement System did not transfer money or anything of value to the District, we conclude that the case sheds little light on whether the prior service liability is a debt.

The District also cites several cases involving whether advances between shareholders and corporations are equity contributions or debt. In those cases, money is advanced and the decision turns on the parties' intent for the recipient to repay the advance. The fundamental question in those cases is not whether a liability is a debt, but whether the corporation is liable to repay the shareholder advances.

The instant case is very different. Here, the Retirement System did not advance money or other value to the District. While the District has a liability to make payments to the Retirement System, these payments are not repayments of an advance, but are payments to fund pension benefits.

The fact that the District had something labeled a prior service liability is only because of the State legislature's choice of actuarial cost method for funding the Retirement System. Pension systems can choose from among several different actuarial cost methods. *See, e.g.*, Martin J. Satinsky, Stephen H. Rosen, and Albert P. Ameiss, *Accountant's Guide to Employee Benefit Plans*, § C5 (1999). Some cost methods involve the calculation of separate past and current service liabilities, and other methods calculate a single liability comprising both. In reality, the prior service liability and the current contributions are one liability, created to fund pension benefits.

Because we find that the prior service liability is not a separate and independent liability to the Retirement System by which the District repays an advance from the System, it cannot be a debt. Nevertheless, we respond to the District's arguments about how classic elements of debt apply to the prior service liability.

To determine whether an advance is debt or equity, courts look at the agreement of the parties. In this case, because there is no instrument memorializing the agreement of the parties, we look to the provisions of the Legislation.

The obligation to pay a sum certain is one aspect of a debt. Here, the amount of the prior service liability is not a sum certain. The District knew that the State could change pension benefits. In addition, given the circumstances, it was reasonable to expect that changes would be made that would increase the prior service liability. When the prior service liability was created on Date 1, the State legislature increased pension benefits over those provided under the predecessor pension systems. This change caused the Date 1 prior service liability to be greater than the aggregate unfunded pension liability under the predecessor systems. That it was reasonable to expect changes to pension benefits is further supported by the fact that the State legislature later passed amendments retroactively improving pension benefits, which increased the prior service liability. And, generally, when the State legislature acted to increase benefits, and when it authorized the system-wide credit, the prior service liability was recalculated using current actuarial assumptions.

It cannot be said that the increases in the prior service liability were new and additional liabilities, thereby not resulting in a change to the Date 1 prior service liability. Generally when each amendment was made, the entire prior service liability was recalculated using then current actuarial assumptions, and, in connection with two of the modifications, the entire prior service liability was reamortized over a new amortization period. Even the prior service liability determined at the time of the merger involved an amount calculated to fund benefits carried over from the predecessor systems.

Another characteristic of debt is that there is a fixed maturity date. An inordinately postponed due date or the absence of a fixed maturity date weighs against characterization as debt. *Harlan v. United States*, 409 F.2d 904, 909 (5th Cir. 1969).

The District notes that debt can exist even if there is not a fixed maturity date, citing *Harlan v. United States, supra*, and *Estate of Mixon v. United States,* 464 F.2d 394 (5th Cir. 1972). In *Harlan v. United States*, a shareholder made two $12,500 advances, one to each of two corporations. The advances were to be repaid only when, and to the extent that, surplus funds of the respective corporations exceeded $12,500. This requirement was in keeping with state law and industry practice. The instruments had no fixed maturity date; instead they were payable upon demand. The corporations repaid the advances within three years. The court found a debt, in part, because it found the payments to be evidence that an early maturity date was contemplated.

A similar analysis appears in *Estate of Mixon v. United States.* While no maturity date was stated in the instrument in that case, the court found that the parties expected repayment to occur within a maximum of three years. Thus, these cases imply that the

absence of a fixed maturity date is not fatal where the parties reasonably expect the amount advanced will be repaid within a relatively short time.

In the instant case, there is no fixed maturity date. The closest thing to a maturity date is the amortization period. That period was used to set the prior service contribution rates using estimated payroll. The actual contributions may not pay the prior service liability within the amortization period if an employer's actual payroll is different than that estimated. Further, the statute contemplated that prior service contributions may extend beyond the amortization period, providing that participating employers must continue their prior service contributions until the prior service liability is paid in full.

Finally, for reasons similar to those stated in the sum certain discussion above, it was reasonable to expect that the State legislature would revise the amortization period, and indeed the length of the amortization period was changed once and the starting date of that period was twice moved to further in the future, effectively extending the amortization period beyond that contemplated on Date 1.

In addition to not having a fixed maturity date, the parties did not expect repayment within a short period. The District did not expect to pay its Date 1 prior service liability for over 35 years.

Payment of interest is another indicator of debt; however, the interest must be compensation for the use or forbearance of money. *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). While the District was required to pay interest to the Retirement System, it did not pay interest for the use of the System's money. Instead, as discussed above, the contributions paid by the participating employers, including interest payments, are deposited into the employer reserve and will be used to pay pension benefits. The amount of the prior service liability, including the subsequent increases and decreases; the rate of interest on the prior service liability; and the current contributions all are set at the amounts estimated to be sufficient, when received and invested by the Retirement System, to fund the benefits. *Cf. Golsen v. Commissioner*, 54 T.C. 742, 753 (1970) ("interest" paid was not compensation for the use of borrowed funds, but was the true cost of the insurance purchased). In addition, there was no forbearance of money. The District's contributions were for a future liability, like a forced savings plan for an expected future liability.

The District responds that the Retirement System is obligated to make payments to the pensioners even if the District fails to make contributions. While the Retirement System may, in form, have this responsibility, it is unlikely ever to be realized. If the District fails to make its contributions to the Retirement System, the State will withhold money it otherwise would pay to the District. Moreover, if the District ceases to exist, the District's successor will be obligated to continue to pay the District's prior service liability and current contributions.

The District also responds that because the prior service liabilities and current contributions are determined, at least in part, on a pooled basis, it is impossible to determine whether the District will completely fund the pension for its employees. The District draws too fine a distinction. While the pooling of liabilities may result in some discrepancies between the amount contributed by a particular employer and the amount paid out to that employer's pensioners, the Retirement System was designed so that generally participating employers would fund their share of employees' pension benefits.

A factor supporting the prior service liability as a debt is the fact that the there is little risk that the District will default on its contributions. Also, the District has made regular contributions, and the State could enforce contributions through withholding payments it would otherwise make to the District. Finally, the District treated the prior service liability as an obligation for accounting purposes.

Nevertheless, considering all of the facts, we conclude that the prior service liability is not debt. First and foremost, the prior service liability is not a separate liability. It, combined with the current contributions, is the method by which the District funds pension benefits.

Even the traditional debt characteristics lead to the conclusion that there is no debt. The prior service liability is not for a fixed or determinable amount. Changes to that liability were expected to occur and did, in fact, occur on several occasions. For similar reasons, there was not a fixed maturity date. Finally, the interest rate charged on the prior service liability was not compensation for the use or forbearance of money.

As we conclude that the prior service liability is not a debt, therefore, it is not an obligation. Accordingly, the taxable notes are not a refunding issue.

B. The Taxable Notes

Because we conclude that the prior service liability is not a debt, we must determine whether the proceeds of the taxable notes were invested, and if invested, whether any of the proceeds will transfer to the Bonds. In addition, the yield on any investments that transfer to the Bonds must be compared to the yield on the Bonds.

The District states that even if the Internal Revenue Service determines that the prior service liability is not a debt, it spent the proceeds of the taxable notes when it paid its prior service liability. The District asserts that the payment of the liability was an expenditure even if the working capital rules would require that the proceeds-spent-last rule apply. *See* 1.148-6(d)(3). Thus, the District argues there are no unspent proceeds of the taxable notes to transfer to the Bonds.

We conclude that the proceeds of the taxable notes were not spent because the District used those proceeds to acquire investment property. That investment property is reflected in the benefit that the District receives from the Retirement System's investments. The benefit can be characterized in two ways. First, that the District indirectly acquired an interest in securities and obligations held by the Retirement System. Second, that the District acquired investment-type property because it acquired a deferred payment contract.

Investment property includes securities and obligations. § 148(b)(2)(A) and (B). Generally, issuers cannot use bond proceeds to directly or indirectly purchase securities or obligations if the yield on those investments is materially higher than the yield on the issue.

In Revenue Ruling 80-257, 1980-2 C.B. 52, a state created a pension fund, separate from the state and the city, for the city's firefighters. The state established the amount of benefits that the pension fund would pay to the pensioners based on age, salary and years of service, but not on investment return. The liabilities of the pension fund were the liabilities of the city, and the city was required to levy sufficient taxes to pay its unfunded liability over a 20-year period and to pay its current contributions. The city proposed to issue bonds to pay its unfunded liability. The pension fund would invest the proceeds of the bonds in investments with materially higher yields than the yield on the bonds. The city expected that the investment return on those investments would substantially decrease the amount of taxes it needed to collect. The ruling concludes that the prospective bonds would be arbitrage bonds because the success or failure of the investments in the pension fund would directly affect the amount of taxes that the city must levy in future years. In other words, the city anticipated a substantial direct benefit from the investments.

Similarly, in this case, when the District transferred the proceeds of the taxable notes to the Retirement System, the proceeds were invested, and the proceeds and investment earnings on those proceeds are used to reduce current contribution rates. While the employer reserve receives the remainder of investment earnings after the payment to the employee reserve, the return on the employer reserve has always exceeded the annual investment return. Moreover, it is reasonable to expect that the return on the employer reserve will continue to exceed the annual investment return because the assumed rate, which is the Board's estimated long-term investment rate, exceeds the rate that is to be received by the employee reserve. As a result, the success of investments credited to the employer reserve directly affects the amount that the District has to pay in current contributions. Accordingly, we conclude that the District indirectly acquired with the proceeds of the taxable notes a pro rata share of each investment credited to the employer reserve.

The District declined to represent whether investments acquired with the proceeds of the taxable notes will be liquidated and spent for pension benefits before

the Bonds are issued. Without this representation, we cannot conclude that the proceeds will be spent before the Bonds are issued. The information submitted by the District does not support a conclusion that the proceeds will be spent.

Because the proceeds are going to be used to pay pension benefits, which is a working capital expenditure, those proceeds are subject to the proceeds-spent-last rule of § 1.148-6(d)(3). That rule generally provides that any amount that is available to the issuer for working capital expenditures of the type financed by the issue must be used for those expenditures before the bond proceeds.

The District represents that in Year 8, the year preceding Year 9 in which the proceeds of the taxable notes were transferred to the Retirement System, the Retirement System held approximately $d in investments to pay retirement benefits. In the 17 years ending in Year 9, the highest amount that the System has had to pay in pension benefits in any year was approximately $e. Using these numbers, it would take proximately 27 years to fully liquidate the investments to pay pension benefits. While these numbers are for the Retirement System and do not all represent the “available amounts” to the District, they do suggest that it is unlikely that the proceeds of the t able notes will be spent in the near future.

The District also declined to provide a representation on the expected yield on the investments. Without this representation, we cannot determine that the yield on the investments will not be materially higher than the yield on the Bonds. Moreover, the information provided by the District suggests that the yield will be materially higher than the yield on the Bonds. The Retirement System’s annual investment return and the more conservative assumed rate have always been materially higher than the yield on the Bonds. There is nothing to suggest that the Retirement System expects investment rates to decline from historic rates or that it intends to restrict the yield on any of its investments to the Bond yield.

The District argues that Revenue Ruling 80-257 does not apply because the District is not receiving a substantial direct benefit from the Retirement System’s investments. The District argues that the Board has discretion in setting the current contribution rates.

Investment return on money in the Retirement System affects the current contribution rates in two ways: one, through the assumed rate, which is used in computing the present value of elements of the current contribution formula, and two, through the earnings credited to the employer reserve.

The assumed rate is an actuarial factor over which the Board has discretion. If the Retirement System's investment return in a year exceeds the return in prior years, the Board may decide not to use that increase to change the assumed rate; for

example, it may not expect the trend to continue. However, the assumed rate is related to investment return in that it reflects expected long-term investment rates.

In contrast, the Board does not have discretion over how much investment return is credited to the employer reserve. The Board has to credit to the employer reserve the investment earnings on the employer and employee reserves remaining after the employee reserve has received its earnings.

The District argues that an increase in the investment return may not lower current contribution rates because the Board could adjust actuarial factors to offset the increased investment return. The District fails to recognize that without that increase in investment return, the current contribution rates would have been greater when the Board made these adjustments. Thus, investments credited to the employer reserve directly and substantially affect the District's current contribution rates.

The District's investment could also be characterized as investment-type property. Section 1.148-1(e) defines investment-type property as **any** property held principally as a passive vehicle for the production of income, which includes a benefit from the time value of money.

The legislative history to § 148(b) makes it clear that Congress was concerned that issuers were avoiding the arbitrage rules by issuing bonds to purchase annuity or deferred payment contracts to fund pension plans, rather than funding the pension through the purchase of securities or obligations, which would violate the arbitrage rules. As noted above, the House Report provides that,

> ...investment in any taxable security as well as any deferred payment contract (e.g., annuity) or other property held for investment is precluded if the yield on the property is materially higher than the yield on the issue. ... Under this rule, for example, the purchase of an annuity contract to fund a pension plan of a qualified governmental unit would be subject to the same arbitrage restrictions as would direct funding of that plan with bond proceeds. ... Similarly, investment of bond proceeds in any other type of deferred payment investment-type contract to fund an obligation of the issuer or bond beneficiary would be subject to these yield restrictions.

H.R. Rep. No. 99-426, at 552 (1985), 1986-3 C.B. (Vol. 2) 552. The Conference Report adopts these thoughts. H.R. Conf. Rep. No. 99-841, at II-747 (1986), 1986-3 C.B. (Vol. 4) 747.

Here, when the proceeds of the taxable notes were transferred to the Retirement System, the District received a deferred payment contract. The proceeds of the taxable notes were deposited into the employer reserve and were invested. Those proceeds and earnings on those proceeds will be used to pay the District's pension benefits.

Because all of the participating employers' contributions are pooled and invested, there is no way to trace exactly which employer's contributions are paying which employer's pensioners. Nevertheless, because money is fungible and because, as noted above, the Retirement System is designed so that employers will generally fund their employees' pensions, we conclude that the fact that the Retirement System was a pooled system does not affect our analysis.

The District has declined to represent that the deferred payment contract will be spent on pension benefits before the Bonds are issued. Again, we cannot conclude that the proceeds will be spent without this representation. The information provided by the District does not support a conclusion that the proceeds will be spent. The proceeds-spent-last rule, as discussed above, suggests that the proceeds will not be spent.

Also, based on the information provided, one cannot conclude that the only pension benefits that should be relevant for determining whether the proceeds of the taxable notes are spent are pension benefits accruing before Date 1. There is little distinction between prior service and current contributions. There is also not a clear distinction between the pension benefits accruing before Date 1 and the benefits accruing after Date 1. The prior service liability is only an estimate of the pension benefits that accrue before Date 1. If that estimate is wrong, the payments on the prior service liability may be used to fund pension liabilities accruing after Date 1. For example, if actuarial assumptions resulted in the prior service liability exceeding the actual liability for pension benefits that accrued before Date 1, contributions for the prior service liability would be used, in part, for pension benefits accruing after Date 1.

In addition, the District has declined to make a representation on the expected yield on the deferred payment contract. Without this representation, we cannot conclude that it is reasonable to expect the yield will not be materially higher than the yield on the Bonds. The information provided by the District suggests it is reasonable to expect that the yield will be materially higher.

The yield on the contract is the discount rate that equates the payment made to the Retirement System from the proceeds of the taxable notes with the expected pension benefits to be paid from that payment. Stated differently, it is the rate at which the District's payment must accrue to pay the expected pension benefits. The assumed rate is the rate that the Board uses to determine the present value of the expected pension benefits. Accordingly, the yield on the contract should at least be the assumed rate, which historically has always been materially higher than the yield on the Bonds. The District has not represented that it expects the assumed rate to decline from the historical rates.

The District argues that it had valid, noninvestment reasons for making the advance payment and, thus, it did not acquire investment-type property. The District

misreads the rules. While we agree that investment property is property acquired for investment purposes, for certain categories of investment property, investment intent is inferred. The Conference Report confirms this point. It states,

> ... the arbitrage restrictions are expanded to apply to the acquisition of any property held for investment other than another bond exempt from tax under Code section 103. Thus, investment in any taxable security as well as any deferred payment contract (e.g., an annuity) or property held for investment is precluded if the yield on the property is materially higher than the yield on the issue.

H.R. Conf. Rep. No. 99-841, at II-747 (1986), 1986-3 C.B. (Vol. 4) 747.

When an issuer acquires securities, it acquires investment property because the Code infers that the issuer acquired the securities for investment reasons. It does not matter that the issuer had other noninvestment reasons for acquiring the securities.

Similarly, investment intent is inferred for deferred payment contracts, particularly deferred payment contracts to fund a pension plan. First, the House Report suggests that deferred payment contracts to fund a pension plan should be treated consistent with securities or obligations to fund the plan. H.R. Rep. No. 99-426, at 552 (1985), 1986-3 C.B. (Vol. 2) 552. Second, the Conference Report suggests that a specific consideration of investment intent is needed if the issuer acquires property other than any taxable security or deferred payment contract (*e.g.*, an annuity).

Accordingly, the District has acquired investment property either by indirectly acquiring securities and obligations or by acquiring a deferred payment contract.

Because we conclude that proceeds of the taxable notes will transfer to the Bonds and the yield on investments purchased with those proceeds is materially higher than the yield on the Bonds, the Bonds will be arbitrage bonds under § 148.

<u>C. Hedge Bonds</u>

Section 149(g)(1) provides that § 103(a) shall not apply to any hedge bond unless, with respect to the issue of which such bond is a part, the requirements of § 149(g)(2) and 149(f)(3) are met. Section 149(g)(3) defines a hedge bond generally as any bond issued as part of an issue unless (1) the issuer reasonably expects that 85 percent of the spendable proceeds of the issue will be used to carry out the governmental purposes of the issue within the 3-year period beginning on the date the bonds are issued, and (2) not more than 50 percent of the proceeds of the issue are invested in nonpurpose investments (as defined in § 148(f)(6)(A)) having a substantially guaranteed yield for 4 years or more. Section 149(g)(3)(C) provides that a refunding

bond shall be treated as meeting the requirements of § 149(g) only if the original bond met such requirements.

An issue meets the requirements of § 149(g)(2) if the issuer reasonably expects that 10 percent of the spendable proceeds of the issue will be spent for the governmental purposes of the issue within the 1-year period beginning on the date the bonds are issued; 30 percent of the spendable proceeds will be spent for such purposes within the 2-year period beginning on such date; 60 percent of the spendable proceeds will be spent for such purposes within the 3-year period beginning on such date; and 85 percent of the spendable proceeds will be spent for such purposes within the 5-year period beginning on such date. An issue meets the requirements of § 149(f)(3) if the payment of legal and underwriting costs associated with the issuance of the issue is not contingent, and at least 95 percent of the reasonably expected legal and underwriting costs associated with the issuance of the issue are paid not later than the 180th day after the date of the issuance of the issue.

The District has declined to represent when it expects the proceeds of the taxable notes to be spent. Accordingly, we cannot determine that the requirements of § 149(g)(2) will be met. In addition, as noted above, the information provided by the District does not support a conclusion that the District reasonably expects that 85 percent of the proceeds of the taxable notes will be spent on the payment of benefits within three years of the issue date, or a conclusion that the District reasonably expects that the spending schedule of § 149(g)(2) will be met. The Bonds, therefore, will be hedge bonds, and the requirements of § 149(g)(2) will not be met. Accordingly, the exclusion from income provided by § 103(a) will not apply to the Bonds.

Conclusion

We conclude that the interest on the Bonds will not be excluded from income under § 103. The Bonds would be arbitrage bonds under § 148 and hedge bonds that fail to meet the requirements specified in § 149(g)(2).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Assistant Chief Counsel
(Exempt Organizations/Employment Tax
Government Entities)

By: ______________________________
Rebecca L. Harrigal
Chief, Tax Exempt Bond Branch