INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 7, 2001

Number: **200214005**
Release Date: 4/5/2002
Index (UIL) No.: 148.08-00
CASE MIS No.: TAM-136977-01/CC:TEGE:EOEG:TEB

Director, Tax Exempt Bonds
Attention: Clifford Gannett, Manager, TEB Outreach, Planning and Review

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:

Date of Conference:

LEGEND:

District

Association

State

Bonds

$a

$b

$c

$d

$e

f

$g

h percent

Date 1

Date 2

Year 1

Year 2

Company

State Statutes

ISSUE:

Whether the Bonds satisfy the requirements of § 148(f)(4)(D) of the Internal Revenue Code for the exception to rebate for governmental units issuing $5,000,000 or less of bonds?

CONCLUSION:

The Bonds do not satisfy the § 148(f)(4)(D) requirements for the exception to rebate for governmental units issuing $5,000,000 or less of bonds.

FACTS:

The District issued the Bonds on Date 1 under a single Indenture as part of a consecutive series of ten bonds. The Bonds were the first bonds in the series. The remaining nine bonds in the series (the “Additional Bonds”) were issued by nine different State school districts (the “Additional Issuers”). The District’s costs of issuance for the Bonds were $a. The Bonds and the Additional Bonds (collectively, “the Program Bonds”) were issued 15 days apart, beginning on Date 1 and ending on Date 2.

The District and the Additional Issuers issued the Program Bonds on behalf of the Association to fund the Association’s small issuer loan program for Year 2. The District and the Additional Issuers issued the Program Bonds after the Company, the Association’s financial advisor and small issuer loan program administrator, contacted the District and the Additional Issuers on behalf of the Association. According to the Association’s resolution which authorized the small issuer loan program, the purpose of that program is to provide funds for the Association to acquire or construct projects that will be leased to State school districts or to reimburse school districts for their costs incurred for projects. The Association’s resolution provides that, in order “to obtain the full benefits of the exemption from ‘the rebate requirements’”, no issuing district could incur more than $5,000,000 in debt in any calendar year in which the district issued bonds to fund the Association's small issuer loan program. The Indenture limited the District and each of the Additional Issuers to issuing only one series of bonds in the total principal amount of $b, which is less than $5,000,000.

The terms of each of the Program Bonds are identical in all respects other than interest rates and credit quality ratings assigned by a rating agency. The total principal amount of each of the Program Bonds is $b. Consequently, the aggregate principal amount of the Program Bonds is $c (10 x $b). The proceeds of the Program Bonds were deposited into various funds, including the project fund, the debt service reserve fund, the costs of issuance fund, and the redemption fund. The Program Bonds are secured by a single trust estate that consists of the leases and projects financed with the proceeds of the Program Bonds, the proceeds, investments, and investment earnings held in the various funds and accounts of the Program Bonds. The District and the Additional Issuers assigned their interests in the trust estate to the Association.

School district borrowers of the proceeds of the Program Bonds under the small issuer loan program submitted a request and certain information to the Company. No application fee or loan origination fee was required. After review and approval by the State Board of Education and the relevant State legislative committee, the Association entered into the lease with the school district borrower. The Association allocated the proceeds of the Bonds to twelve leases. Ten districts other than the District were parties to ten leases with the Association. The projects financed for these ten districts were educational equipment, improvements to particular schools, and "district wide "improvements. The District was a party to the remaining two leases with the Association, which total $d. The projects financed for the District were improvements to particular schools and "district wide" improvements.

The Association did not conduct a demand survey to assess the extent of State school districts' interest in borrowing under the small issuer loan program or to determine the size of any bond issue to fund that program for Year 2.

From its inception in Year 1 pursuant to the Agreement, the Association was intended to serve as and has served as a State issuing agency for equipment lease revenue bonds in order to afford borrower school districts the benefits of economies in financing that may be realized in a pooled financing, *e.g.*, costs for financial advisor fees, bond counsel fees, and other similar costs may be shared by borrowers who participate in the Association's pooled financings. From Year 1 through Year 2, the Association issued lease revenue bonds in the aggregate principal amount of $e. The proceeds of the Association's bonds were loaned to over f State school districts primarily to purchase equipment under leases between the Association and the borrowing district. The districts' leases secured the Association's bonds. In Year 2, the

Association issued bonds in the total principal amount of not less than $g, which is in excess of $1,000,000.[1]

The proceeds of the Program Bonds were invested in a guaranteed investment contract pursuant to the Investment Agreement. According to the terms of the Investment Agreement, proceeds of the Program Bonds could be withdrawn according to a prescribed draw schedule for any purpose set forth in the Indenture. The agent determined that the yield on the proceeds of the Bonds invested pursuant to the Investment Agreement exceeded the yield on the Bonds by h percent.

LAW AND ANALYSIS:

Section 103(a) provides that, except as provided in § 103(b), gross income does not include the interest on any State or local bond. Section 103(b)(2) provides that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148).

Under § 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. Section 148(f) generally requires that the arbitrage earned be rebated to the United States.

Section 148(f)(4)(D) provides an exception to the § 148(f) rebate requirement for governmental units issuing $5,000,000 or less of bonds. Under § 148(f)(4)(D)(i), the following requirements must be satisfied:

(I) the issue is issued by a governmental unit with general taxing powers,

(II) no bond which is part of the issue is a private activity bond,

(III) 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and

(IV) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by the governmental unit during the calendar year in which such issue is issued is not reasonably expected to exceed $5,000,000.

Under § 150(a)(3), the term “net proceeds” means, with respect to any issue, the proceeds of such issue reduced by amounts in a reasonably required reserve or replacement fund.

Section148(f)(4)(D)(ii) provides, in part, that, for purposes of § 148(f)(4)(D)(i)(IV), an entity formed (or, to the extent provided by the Secretary, availed of to avoid the purposes of § 148(f)(4)(D)(i)(IV) and all other entities benefitting thereby shall be

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[1] This amount may represent only a portion of the Bonds issued by the Association in Year 2.

treated as one issuer. Under § 1.148-8(c)(2)(iii) of the Income Tax Regulations, situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity and the issuer does not receive a substantial benefit from the project financed by the bonds.

Four requirements must be met in order to satisfy the § 148(f)(4)(D) exception to rebate for governmental units issuing $5,000,000 or less of bonds. We assume for purposes of this technical advice memorandum that the Bonds were issued by a governmental unit with general taxing powers and that no bond is a private activity bond. Hence, the Bonds would satisfy the § 148(f)(4)(D)(i)(I) and (II) requirements.

<u>Less than 95 percent of the Bonds were used for local government activities of the issuer</u>

We conclude that the Bonds fail to satisfy the § 148(f)(4)(D)(i)(III) requirement that 95 percent or more of the net proceeds are to be used for the District's local government activities or for a governmental unit entirely within the jurisdiction of the District. Assuming that the Association's allocations are correct, proceeds of the Bonds were allocated to a total of twelve leases. The District entered into two of these leases, which total $<u>d</u>, an amount which is less than 95 percent of the net proceeds of the Bonds. Ten school districts other than the District entered into the remaining leases. The projects financed for the ten districts other than the District were educational equipment, improvements to particular schools within these ten districts, and "district wide" improvements within these ten districts. Hence, 95 percent or more of the proceeds of the Bonds were not used for projects within the District's jurisdiction.

The District argues that the State Statutes should be interpreted to create a joint responsibility among the District and other State school districts to educate students in other State school districts and, hence, that the projects financed in the other districts also benefitted the District. We disagree. The State Statutes make no mention of school district jurisdiction, authority, or responsibility. Furthermore, the District presented no facts to establish that it and the ten borrower school districts are jointly responsible for the education, safety, or similar matters of all State students, rather than only those students within each individual district's authorized jurisdiction. The District presented no facts to indicate that the ten other districts are entirely within the jurisdiction of the District.

<u>The Bonds, when appropriately aggregated, are part of an issue of bonds that exceeds $5,000,000</u>

We also conclude that the Bonds fail to satisfy § 148(f)(4)(D)(i)(IV) because, when entities are appropriately aggregated, the aggregate face amount of all tax-exempt bonds issued by the District in Year 2 exceeds $5,000,000.

Under § 148(f)(4)(D)(ii)(IV) and § 1.148-8(c)(2)(iii)(A), the Association availed of the District to avoid the purposes of § 148(f)(4)(D)(i)(IV) because (1) but for the $5,000,000 size limitation, the Association would have issued the Bonds as part of a larger issue of bonds; and (2) the District did not receive a substantial benefit from the projects financed with the proceeds of the Bonds. The Agreement authorizing the formation of the Association designates the Association as an issuing agency for State lease revenue pooled financings such as the Program Bonds, the purpose of which is to eliminate the need for State school districts to independently incur costs to independently issue bonds. Consistent with its purpose, the Association issued multiple lease revenue pooled bond issues from Year 1 through Year 2 in the aggregate principal amount of not less than $e and did so for the same purpose for which the District issued the Bonds on the Association's behalf, *i.e.*, to make funds available to State school districts to purchase equipment under leases between the Association and the borrowing district. Nonetheless, instead of adhering to its six-year practice of serving as an issuing agency for lease revenue pooled bond issues, the Association, through the Company, its financial advisor and administrator of the small issuer loan program, solicited the District and the Additional Issuers to issue bonds on behalf of the Association.

Although soliciting the District and the Additional Issuers to issue the Program Bonds ignores the Association's purpose to act as an issuing agency, no business purpose was provided to explain this change. However, the Association's resolution authorizing the small issuer loan program provides that, in order "to obtain the full benefits of the exemption from 'the rebate requirements'", no issuing district could incur more than $5,000,000 in debt in any calendar year in which the district issued bonds to fund the Association's small issuer loan program. The facts are consistent with the resolution statement. The Association limited the District and the Additional Districts to issuing each of the Program Bonds in the total principal amount of $b and offered no business purpose to explain this limitation. The size of the Program Bonds was not based on the results of a demand survey, but, instead, the aggregate principal amount of the Program Bonds was based on the number of issuers that the Association solicited to issue bonds.

Moreover, the Association administered the Program Bonds as if the Association had issued those Bonds. Neither the District nor any of the Additional Issuers managed or were involved in any aspect of the administration of the Association's small issuer loan program. Instead, the Association created the small issuer loan program and all borrower districts, including the District, applied directly to the Association to borrow from that program. The Association retained the sole program administrator for the small issuer program and there are no facts to indicate that the District or the Additional Issuers provided input or were permitted to approve the Association's selection. The Association, not the District or any Additional Issuer, entered into the lease with the borrower school district. The Bonds were issued pursuant to a single Indenture and are secured by a single trust estate that consists of the leases and projects financed with the proceeds of the Program Bonds, the proceeds, investments, and investment earnings in the various funds and accounts of the Program Bonds. Furthermore, although the District issued the Bonds and could have financed its projects without participating the Association's small issuer loan program, the District did not do so. Instead, the District provided the proceeds to the Association to partially fund the small issuer program and then borrowed from that program to finance projects within the District.

The District did not receive a substantial benefit from the projects financed with the proceeds of the Bonds. Assuming that the Association's allocations of expenditures to the proceeds of the Bonds are correct, twelve leases were financed with those proceeds. The District borrowed to finance the costs of improvements to particular schools within the District and to finance "district wide" improvements within the District. We do not question that the District benefitted from these projects. However, the Association also allocated ten leases for projects in ten school districts other than the District to the Bonds. These ten leases financed educational equipment, improvements to particular schools, and "district wide" improvements within the jurisdiction of districts other than the District. *i.e.*, projects that substantially benefitted the other districts. The District presented no facts to establish that it and the borrowing districts are jointly responsible for the education, safety, or similar matters of all State students, rather than only those students within each individual district's jurisdiction, and, thus, that the District substantially benefitted from projects outside of its jurisdiction. Hence, we conclude that under § 1.148-8(c)(2)(iii), the District did not receive a substantial benefit from the projects financed by the Bonds.

Having concluded that the Association availed of the District to avoid the purposes of § 148(f)(4)(D)(IV), we next consider whether the aggregate amount of bonds issued by the District exceeds $5,000,000. The Association benefitted from the fact that it used the District to avoid the purposes of § 148(f)(4)(D)(ii)(IV). This benefit consisted of additional investment proceeds, because of retained rebatable arbitrage, that the Association used to pay administrative costs and to make additional loans. Because of the Association's use of the District and its benefit therefrom, it is appropriate to aggregate the bonds issued by the Association and the Bonds issued by the District.[2] As a result of this aggregation, because the Association issued more than $1,000,000 in bonds in Year 2, the District is deemed to have issued more than $5,000,000 in bonds. Thus, the Bonds are subject to rebate.

CAVEAT(S)

Because our conclusion in this case was based on the § 148(f)(4)(D)(ii) aggregation rule, we express no opinion as to whether the Program Bonds may constitute a single issue under § 1.150-1(c). In addition, we express no opinion as to whether the Bonds may be appropriately aggregated with bonds issued by entities other than the Association.

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.

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[2] If additional facts demonstrate that the Association similarly availed of the Additional Issuers to avoid the purposes of § 148(f)(4)(D)(i)(IV), it would be appropriate to aggregate bonds issued by the Association and each of the Additional Issuers.