INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No

Date of Conference:

LEGEND:

Issuer =

State =

Series A Bonds =

Series B Bonds =

Prior Bonds =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

a =

b =

c =

d =

e =

f =

g =

q =

r =

w =

x =

y =

z =

ISSUE(S):

1. Whether the Series A and B Bonds are a single issue under § 1.150-1(c) of the Income Tax Regulations.

2. Whether the Series A and B Bonds are arbitrage bonds under § 148 of the Internal Revenue Code of 1986 (the "1986 Code") and § 1.148-10.

CONCLUSION(S):

1. The Series A and B Bonds should be treated as a single issue under § 1.150-1(c)(5) to clearly reflect the economic substance of the transaction and to prevent avoidance of § 148.

2. Alternatively, the Series A Bonds are arbitrage bonds under § 1.148-10(e). While § 1.148-10(e) also applies to the Series B Bonds, we do not have enough facts to conclude whether the Series B Bonds are arbitrage bonds. We further conclude that the Series A and B Bonds are taxable advance refunding bonds under § 149(d)(4).

FACTS:

The Issuer is a political subdivision of State. On Date 1, the Issuer issued the Series A and B Bonds (collectively referred to as the "Refunding Bonds") totaling approximately $a, $b of which was used to advance refund the Prior Bonds. The Issuer states that the purpose for the advance refunding was to restructure its debt service payment schedule to more closely align the schedule with its revenue cycle, in particular with its tax revenues. No significant covenant in the Prior Bonds' documents was removed when the Refunding Bonds were issued. In addition, as further explained below, no debt service savings was realized from the refunding, and the annual debt service payment on the Prior Bonds is approximately equal to the annual debt service payment on the Refunding Bonds.

The Prior Bonds

The Prior Bonds were issued in Year 1 to fund renovation and construction projects of the Issuer. The Prior Bonds are capital appreciation bonds, the last of which matures in Year 2. The Prior Bonds are not subject to voluntary or mandatory redemption prior to maturity. The Prior Bonds are general obligation bonds payable from the general revenues of the Issuer, including taxes collected by the Issuer and receipts from the State. The yield on the Prior Bonds is w%, which is materially higher (within the meaning of § 1.148-3) than the yield on the Series A or B Bonds.

On the date the Refunding Bonds were issued, the Prior Bonds had $ c in principal outstanding. The annual debt service on the Prior Bonds is approximately $d, paid in April and October with the larger of the two payments due in October.

The Refunding Bonds

The Series A and B Bonds were sold at substantially the same time and pursuant to the same plan of financing, within the meaning of § 1.150-1(c).[1]

The offering documents for the Series A Bonds provide that those Bonds are limited obligation revenue bonds paid from, and secured by, only funds received from State in the form of reimbursements and educational subsidies (the "State Revenues"). The documents further provide that the Issuer has not pledged its full faith, credit, and taxing power to pay the Series A Bonds.

The Series A Bonds pay interest currently and will fully mature in Year 4. The debt service on the Series A Bonds is paid from a sinking fund (the "Series A Bonds Sinking Fund"), which must be funded four times a year pursuant to the following schedule:

Scheduled Funding Date	Funding Requirement
August 31	100% of interest due next October 1
October 31	33% of principal and interest due next April 1
December 31	33% of principal and interest due next April 1
February 28	34% of principal and interest due next April 1

Deposits into the Series A Bonds Sinking Fund are made from monies in the Issuer's general fund.

The proceeds of the Series A Bonds will pay debt service on the Prior Bonds from Date 2 through final maturity of the Prior Bonds in Year 2. Thus, the Series A

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[1] Section 1.148-11(a) provides that, except as otherwise provided in § 1.148-11, §§ 1.148-1 through 1.148-11 apply to bonds sold on or after July 8, 1997, a date that is after the sale date of the Refunding Bonds. However, § 1.148-11(b) generally provides that, except as otherwise provided in § 1.148-11, and subject to the effective dates for the corresponding statutory provisions, an issuer may apply the provisions of §§ 1.148-1 through 1.148-11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject to § 148(f) of the 1986 Code or to §§ 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954 (the "1954 Code"), in lieu of otherwise applicable regulations under those sections.

The agent and the Issuer make specific reference in their submissions to § 1.150-1(c)(1), which could not have applied to the Refunding Bonds without the Issuer making the election under § 1.148-11(b)(1). Accordingly, we apply the relevant current regulations under §§ 148 and 150 in our analysis.

Bonds will be completely redeemed before the proceeds of those Bonds begin paying debt service on the Prior Bonds. Until the time that those proceeds are needed to pay debt service on the Prior Bonds, they, along with a payment the Issuer received under a forward supply agreement, are irrevocably deposited in an escrow invested in Treasury securities. Initially, the yield on the escrow was not materially higher than the yield on the Series A Bonds, which is x%. However, as the Series A Bonds were redeemed, the Issuer, applying the universal cap rule of § 1.148-6(b)(2), invested proceeds that it treated as deallocated from the Series A Bonds at a yield that while not materially higher than the yield on the Prior Bonds, was materially higher than the yield on the Series A or Series B Bonds.

The Series B Bonds are general obligations of the Issuer, payable from the Issuer's tax and other general revenues, including State Revenues. The Issuer has pledged its full faith, credit and taxing power for the repayment of the Series B Bonds.

A small amount of the Series B Bonds, $e, pay interest currently and will mature by Year 3 (the “Series B current pay bonds”). The rest of the Series B Bonds, $f, require no current interest payments, but are capital appreciation bonds that mature between Year 4 and Year 2 (the “Series B capital appreciation bonds”). Accordingly, the Series B Bonds require minimal debt service payments for the first six years following issuance.

The annual debt service on the Series B current pay bonds is paid in April and October, with the October payment generally being substantially larger than the April payment. The entire annual debt service on the Series B capital appreciation bonds is paid each October; no payment is required in April. The debt service payments on all the Series B Bonds are made from monies in the Issuer's general fund.

Most of the Series B Bond proceeds were deposited into an escrow to pay debt service on the Prior Bonds from Date 3 through Date 4, a period that ends approximately eight years before the Series B capital appreciation bonds fully mature. The remainder of the Series B Bond proceeds, $ g, was used for capital improvements and for cost of issuance.

The escrow funded by the proceeds of the Series B Bonds is invested in Treasury securities. The yield on the Series B Bonds is y%, while the yield on the escrow funded with the proceeds of the B Bonds is z%. This escrow yield is not materially higher than the yield on the Series B Bonds, but is materially higher than the yield on the Series A Bonds.

Issuer Revenues

The Issuer receives State Revenues every two months in approximately equal amounts. These funds, once received, are deposited into the Issuer's general fund along with tax and other revenues. The deposits to the Series A Bonds Sinking Fund are due within the same month that State Revenues are received.

The offering documents for the Refunding Bonds provide that State Revenues for the ten years preceding the issuance of the Refunding Bonds have comprised approximately q to r% of the total Issuer's revenues. Assuming that the Issuer's past funding levels continue during the term of the Refunding Bonds, the State Revenues will exceed the required payments to the Series A Bonds Sinking Fund.

The Issuer generally receives its tax revenues each year after October and before April. As noted above, the Issuer asserts that the purpose for the Refunding Bonds was to permit debt service payments on the Refunding Bonds to better match its tax revenues. The Issuer states that, prior to issuing the Refunding Bonds, it needed to issue revenue anticipation notes (RANs) to cover its cash flow deficits in the months preceding the October payment on the Prior Bonds. The Issuer notes that since the Refunding Bonds were issued, it has not needed to issue RANs.

LAW AND ANALYSIS:

General provisions

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

Section 148(a) defines the term "arbitrage bond" to mean 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. Further, § 148(a) provides 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 § 148(a)(1) or (2). Section 148(f) generally defines an arbitrage bond as a bond that fails to meet the requirements of § 148(f)(2) and (3) (relating to rebate to the United States of certain investment earnings).

Section 148(b) generally defines higher yielding investment as any investment property which produces a yield over the term of the issue that is materially higher than the yield on the issue. The regulations define "materially higher" as a yield on the investments over the term of the issue that exceeds the yield on the issue by an amount

in excess of the applicable definition of materially higher set forth in § 1.148-2(d)(2). Materially higher for refunding escrows or for investments allocable to replacement proceeds means one-thousandth of one percentage point. § 1.148-2(d)(2)(ii).

Law and analysis on issue 1

The first issue is whether the Series A and B Bonds are a single issue. The agent states that if the Series A and B Bonds are a single issue, they are arbitrage bonds because the yield on the combined escrows is materially higher than the yield on the Refunding Bonds.

Section 1.150-1(a)(1) provides that, except as otherwise provided, the definitions in § 1.150-1 apply for all purposes of §§ 103 and 141 through 150. Section 1.150-1(c)(1) provides that, except as otherwise provided in § 1.150-1(c), the term "issue" means two or more bonds that meet all of the following requirements:

(i) The bonds are sold at substantially the same time.
(ii) The bonds are sold pursuant to the same plan of financing.
(iii) The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

Section 1.150-1(c)(5) provides that, in order to prevent the avoidance of §§ 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

The agent and Issuer appear to agree that the Series A and B Bonds were sold on the same date pursuant to the same plan of financing. Thus, the Series A and B Bonds are one issue if they were reasonably expected to be paid from substantially the same source of funds. However, because we conclude that, based on the economic substance of the transaction under § 1.150-1(c)(5), the Series A and B Bonds should be treated as a single issue, we do not address whether the Series A and B Bonds are reasonably expected to be paid from substantially the same source of funds under § 1.150-1(c)(1). Our rationale for applying § 1.150-1(c)(5) in this case overlaps considerably with our rationale for applying § 1.148-10(e) and is combined with our discussion of § 1.148-10(e).

Law and analysis on issue 2

The second issue is whether the Refunding Bonds are arbitrage bonds under § 1.148-10. We also discuss whether § 149(d)(4) applies to the Refunding Bonds.

Section 1.148-10(e) provides that if an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of §§ 1.148-1 through 1.148-11 as necessary to clearly reflect the economic substance of the transaction. For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148.

Section 1.148-0 provides that § 148 was enacted to minimize the arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. *A fortiori*, if an issuer does not have a governmental purpose for issuing bonds apart from earning arbitrage, the issuance of the bonds is inconsistent with the purpose of § 148.

Section 1.148-10(d), *Example* 2(ii) and (iii), illustrates the application of § 1.148-10 where the transaction involves refunding of noncallable bonds. In 1994, Authority issues an advance refunding issue (the refunding issue) to refund a 1982 prior issue (the prior issue). Under current market conditions, Authority will have to invest the refunding escrow at a yield significantly below the yield on the refunding issue. Authority will also refund other long-term, non-callable bonds in the same refunding issue. There are no savings attributable to the refunding of the non-callable bonds. Authority invests the portion of the proceeds of the refunding issue allocable to the refunding of the non-callable bonds in the refunding escrow at a yield that is higher than the yield on the refunding issue, based on the relatively long escrow period for this portion of the refunding. The Authority invests the other portion of the proceeds of the refunding issue in the refunding escrow at a yield lower than the yield on the refunding issue. The blended yield on all the investments in the refunding escrow for the prior issues does not exceed the yield on the refunding issue. The portion of the refunding issue used to refund the noncallable bonds, however, was not otherwise necessary and was issued primarily to exploit the difference between taxable and tax-exempt rates for that long portion of the refunding escrow to minimize the effect of lower yielding

investments in the other portion of the escrow. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds. The existence of a governmental purpose would not change the conclusions unless Authority clearly established that the primary purpose for the use of the particular structure was a bona fide governmental purpose. The fact that the financing structure had the effect of eliminating significant amounts of negative arbitrage is strong evidence of a primary purpose that is not a bona fide governmental purpose.

Section 149(d)(1) provides that nothing in § 103(a) or any other provision of law will be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in § 149(d)(2), (3), or (4). Section 149(d)(4) provides that an issue is described in that section if any bond (issued as part of the issue) is issued to advance refund another bond and a device is employed in connection with the issuance of such issue to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates.

Section 149(d) was enacted as part of § 1301(b) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, 520. The Senate Report to that Act describes § 149(d) and provides examples of the types of transactions that are treated as devices for § 149(d)(4). In *Example 4*, pursuant to a series of transactions, a prior issue is refunded by issuing (1) long-term advance refunding bonds (intended to be tax-exempt) to pay debt service on the prior issue in the early years, and (2) short-term advance refunding bonds (not intended to be tax-exempt) to pay debt service on the prior issue in the later years. Proceeds of the short-term advance refunding issue are invested at a yield materially higher than the yield on both the short-term and the long-term advance refunding issues. By separating the two issues, the issuer has attempted to exploit the difference between the taxable rate at which proceeds of the short-term advance refunding issue are invested and the tax-exempt rate of the long-term advance refunding issue. If a material financing advantage has been obtained by separating the two issues, the issuer has employed a device in connection with the issuance of the long-term advance refunding bonds to obtain a material financial advantage apart from savings attributable to lower interest rates. S. Rep. No. 99-313, at 851 (1986), 1986-3 (Vol. 3) C.B. 851.[2]

We first consider whether the issuance of the Refunding Bonds was inconsistent with the purposes of § 148. The Issuer asserts that it issued the Refunding Bonds to better match its debt service payments to its tax revenues. In particular, the Issuer

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[2] The Conference Report, H. R. Conf. Rep. No. 99-814, at II-758 (1986), 1986-3 (Vol. 4) C.B. 758, follows the Senate's prohibition on advance refunding transactions that involve a device to obtain a material financial advantage based on arbitrage other than savings from a reduction in interest rates.

points out that while the October debt service payment on the Prior Bonds is substantially larger than the April debt service payment on the Prior Bonds, its tax revenues are generally not received until after the October and before the April debt service payment dates. The Issuer supports its assertions by stating that, while in years preceding the issuance of the Refunding Bonds it had to issue RANs to cover its cash shortfall, it has not had to issue similar RANs since the year the Refunding Bonds were issued.

We cannot accept the Issuer's argument because it is not supported by the facts. The offering documents state that the Series A Bonds are supposed to be paid from State Revenues, not tax revenues. The Series A Bonds require sinking fund payments to be made in the same months that the Issuer receives State Revenues and State Revenues are anticipated to far exceed the debt service on the Series A Bonds.

If there were a revenue matching problem with the Prior Bonds, it should have been cured with the Series B Bonds because those Bonds are payable from tax and other general revenues. To cure the revenue matching problem, the larger debt service payments on the Series B Bonds should have been scheduled in April, after the majority of the tax revenues are received. The Series B current pay bonds, however, generally continue to require the larger debt service payment to be made in October. Moreover, beginning in Year 4, when the Series B capital appreciation bonds begin to mature, the entire annual debt service on the Series B Bonds is paid in October. It is not surprising that the Issuer has not needed to issue RANs since it issued the Refunding Bonds because the Series B Bonds pay only minimal debt service payments until Year 4. Thus, based on the information provided by the Issuer, the Issuer could not have achieved a better matching of debt service payments to tax revenues with the Refunding Bonds.

The Issuer has not given any other reason for issuing the Refunding Bonds and none is apparent from the facts provided. Thus, we agree with the agent that the Issuer did not have a governmental purpose for the Refunding Bonds.

The Issuer also obtained a material financial advantage based on the difference between the taxable and tax-exempt rates by structuring the refinancing transaction to 1) treat the Series A and B Bonds as separate issues; 2) redeem the Series A Bonds early by creating a window in the debt service requirements on the Series B Bonds, thereby allowing almost all of the revenues that would have been used to pay the Prior Bonds to pay interest and principal on the Series A Bonds; and 3) delay the time when the proceeds of the Series A Bonds would be used to pay the debt service on the Prior Bonds, thereby allowing the Issuer to increase the time that Series A Bond proceeds are invested at a materially higher yield. Using this combined structure and applying the universal cap rule of §1.148-6(b)(2), the Issuer reallocated proceeds from the Series A

Bonds to the Prior Bonds and invested those reallocated proceeds at a yield that was materially higher than the yield on the Series A and B Bonds. Thus, it is appropriate to recharacterize the transaction to reflect the economic substance of the transaction even if we need to depart from the rules of §§ 1.148-1 through 1.148-11.

We conclude that the economic substance of this transaction is represented by allocating the longer term investments to the longer term bonds and the shorter term investments to the shorter term bonds. In reallocating the investments, the investments in the escrow created with the Series B Bond proceeds are properly allocated to the Series A Bonds to the extent that escrow does not exceed the outstanding principal of the Series A Bonds. The yield on the Series B Bond escrow is materially higher than the yield on the Series A Bonds. The investments in the escrow created with the proceeds of the Series A Bonds are properly allocated to the Series B Bonds. Because the Series B Bonds were not redeemed in the same manner as the Series A Bonds, it appears that there is no deallocation of the Series B Bonds under the universal cap rule and the investments purchased with proceeds of the Series A Bonds remain allocated to the Series B Bonds. While the yield on the escrow created with the Series A Bonds originally was not materially higher than the yield on the Series A (and Series B) Bonds, eventually those proceeds were invested at a yield that was materially higher than the yield on the Series A and Series B Bonds. The facts submitted do not provide a computation from which we can conclusively determine whether the yield on the escrow created with proceeds of the Series A Bonds and the portion of the escrow created with proceeds of the Series B Bonds that remains allocated to the Series B Bonds (*i.e.*, the portion of the Series B Bond escrow that is not allocated to the Series A Bonds), is materially higher than the yield on the Series B Bonds.

Alternatively, but for similar reasons, we conclude that, to prevent avoidance of § 148 and the purposes for § 148, the Series A and B Bonds should be treated as a single issue under § 1.150-1(c)(5). The only reason for separating what was a single refinancing transaction into two issues was to avoid the investment limitations in § 148 to obtain a material financial advantage based on the difference in taxable and tax-exempt interest rates in a manner that is inconsistent with § 148. The separation did not reflect the economic substance of the refunding because the short term bonds (the Series A Bonds, which mature by Year 4) were used to pay debt service on the Prior Bonds in the later years (from Date 2 through Year 2) and the longer term Bonds (the Series B Bonds, which do not fully mature until Year 2) were used to pay debt service on the Prior Bonds in the early years (from Date 3 through Date 4).

Finally, we conclude that the Refunding Bonds are taxable advance refunding bonds described in § 149(d)(4). The Issuer, in connection with an advance refunding issue, has employed a device similar to the device described in the *Example 4* in the Senate Report describing § 149(d), to obtain a material financial advantage apart from

savings attributable to lower interest rates. As indicated above, because the Prior Bonds are not subject to redemption prior to maturity, the Issuer cannot obtain any savings attributable to lower interest rates. The Issuer, by separating a single refinancing issue into two issues and applying the universal cap rule to the Series A Bonds, was able to invest proceeds of the Series A Bonds at a materially higher yield than the yield on the Series A and B Bonds.

CAVEAT(S):

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