

Lesson 3

Valid Issuer / Valid Debt

Overview

Purpose	The purpose of this lesson is to provide the student with a detailed examination of the legal analysis used to determine whether an entity is a valid issuer of tax-advantaged bonds and whether the obligation of an issuer is a valid debt for the purpose of tax-advantaged treatment by the Code.
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Objectives	<p>At the end of this lesson, you will be able to:</p> <ul style="list-style-type: none">• List at least five types of entities that are eligible to issue tax-exempt debt• Define the police power, the taxing power, and the eminent domain power and explain their significance in the field of tax-exempt bonds• Identify the two types of “on behalf of issuers”• Distinguish between the two types of “on behalf of issuers”• Describe the characteristics an obligation must have in order to be eligible to be treated debt for purposes of § 103
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Overview, Continued

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Section 1

State or Political Subdivision

Interest Exclusion

Interest on any state or local bond is not included in gross income, except as provided under § 103(b):

Nonqualified private activity bonds. A private activity bond must be qualified to be tax-exempt. See § 141(e).

An arbitrage bond. The interest on a bond issued for the purpose of earning arbitrage is included in gross income. See § 148.

Non-registered bonds, etc. Bonds must generally meet the requirements of § 149 to be tax-exempt.

State or Local Bond

"**State or local bond**" means an obligation of a State or **political subdivision** thereof. Section 103(c)(1).

The term "governmental unit" does not include the United States or any agency or instrumentality thereof. Section 150(a)(2).

District of Columbia and Territories

The District of Columbia (see Rev. Rul. 76-202, 1976-1 C.B. 26) and any possession of the United States (U.S. Virgin Islands, Puerto Rico, Northern Marianas Islands, Samoa, and Guam) are included as "**states**."

Section 2

Political Subdivisions

Definition "Political subdivision" denotes any division of any state or local government unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. See Regulations § 1.103-1(b).

In determining whether an organization is a division of a state or local governmental unit, important considerations are the extent the organization is (1) controlled by state or local government unit, and (2) motivated by a wholly public purpose. See Rev. Rul. 83-131, 1983-2 C.B. 184

Sovereign Powers In *Commissioner v. Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945), the U.S. Court of Appeals for the Second Circuit identified three sovereign powers the presence or absence of which form the basis for determining whether an entity is a political subdivision:

- the power of eminent domain;
- the power to tax; and
- police power

The court in *Shamberg* stated that only part of the sovereign power of the governmental unit needs to be delegated to an issuer in order to qualify as a "political subdivision." However, if only an insubstantial amount of any or all sovereign powers are delegated, then the entity is not a political subdivision.

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Political Subdivisions, Continued

Police Power

In Rev. Rul. 77-164, 1977-1 C.B. 20, a community development authority was held not to possess police power where it had only limited authority to adopt and enforce rules regarding use of community facilities and such authority was subordinate to the police power of the municipality in the event of conflict.

In *Philadelphia National Bank v. United States*, 666 F.2d 834 (1981), Temple University was held not to possess the police power by maintaining a campus police force authorized by state law to enforce only state laws but not university enacted rules or regulations. This was characterized by the court as "a minimal grant of police power" and as "limited authorization to exercise one small aspect of police power — one that has been delegated to private organizations as well." (See also Technical Advice Memorandum 8119061.) However, where a transit authority has the power to set rates, determine routes, and enforce its regulations by maintaining a security force, it is considered to possess police powers. See Rev. Rul. 73-563, 1973-2 C.B. 24.

Power to Tax

In Rev. Rul. 77-164, 1977-1 C.B. 20, the power to tax was not considered present where service and user fees assessed and collected by a community development authority were only for the benefit of property owners of the improvements, and not for the purposes of raising revenues for public or governmental purposes.

In *Philadelphia National Bank v. United States*, *supra*, Temple University did not possess the power to tax because it was a beneficiary of the state's taxing power through the appropriation of funds to the University.

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Political Subdivisions, Continued

Eminent Domain

In Rev. Rul. 77-165, 1977-1 C.B. 21, only limited and specific delegations of the state's power of eminent domain (the power to take private property for public use) could be made to a state university under state law. The Service found that the right to exercise the power of eminent domain in specific projects designated by the legislature was not a substantial power of eminent domain. Lacking other substantial sovereign powers, the university was denied political subdivision status.

A similar result was reached in *Philadelphia National Bank v. United States*, supra. Here the state authority had to accept and implement Temple University's requests to condemn property. Temple was held not to possess the power of eminent domain.

Facts and Circumstances are Important

In PLR 8630027, a proposed Development District with the power of eminent domain and power to tax was held not to be a qualified issuer of governmental obligations since it did not qualify as a political subdivision of a state. In that PLR, a for profit corporation proposed to petition a local municipality to establish a "Development District" that was coterminous with the acreage of land owned by the corporation. The Development District would be controlled by a five-member board of supervisors elected by the district landowners (which would be the corporation only). The Development District would possess the power to tax and the power of eminent domain but would not have police powers. The Development District's power of eminent domain would cover its district property (and other property subject to the approval of the county or municipality) for purposes relating solely to district roads and water and sewage management. The PLR determined that the Development District would not possess substantial powers of taxation or eminent domain to qualify as a political subdivision since the Development District (wholly controlled by the non-exempt corporation) would be delegated "no materially greater sovereign powers over the Development District land than the corporation inherently would have if the Development District were never created."

Section 3

On Behalf of Issuers

General Rule

An entity that fails to qualify as a political subdivision may be able to issue tax-exempt bonds "on behalf of" a state or local governmental unit as a "constituted authority" or as a "63-20 corporation."

“Constituted Authorities”

An obligation issued by or on behalf of any state or local governmental unit by a *constituted authority* empowered to issue such an obligation is the obligation of such a unit. See § 1.103-1(b)

There is no definition of “constituted authority” in either the Internal Revenue Code or the Regulations. However, Rev. Rul. 57-187, 1957-1 C.B. 65, holds that bonds are considered issued on behalf of a political subdivision of the state where: (1) the political subdivision has approved the creation of the issuer and the form of the issuer’s certificate of incorporation; (2) the board of directors of the issuer is elected by the governing body of the political subdivision and serves without compensation; (3) the issuer's corporate powers include the power to acquire, improve, maintain, equip, and furnish projects; to lease such projects and collect rent; to sell and convey any and all of its property whenever the board of directors find such action to be in furtherance of the purposes for which it was organized; and to issue bonds for the purpose of carrying out any of its powers; (4) all bonds are payable solely out of revenues and receipts derived from the leasing or sale of its projects; (5) the political subdivision is not liable for the payment of principal or interest on any of the bonds; (6) the issuer is exempt from all state taxation, and interest on bonds issued by the Board is exempt from state taxes; (7) the issuer is a nonprofit corporation and no part of its net earnings may inure to the benefit of any private person; and (8) upon dissolution of the issuer, the title to all property owned by it shall vest in and become the property of the political subdivision in which the issuer is located.

See also Rev. Rul. 60-248, 1960-2 C.B. 35; PLR 200307004.

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On Behalf of Issuers, Continued

“63-20 Corporations”

"63-20 corporations" are formed under state nonprofit law for purposes of issuing obligations **on behalf of** a political subdivision.

Under Rev. Rul. 63-20, obligations issued by a nonprofit corporation formed under the general nonprofit corporation law of a state will be considered issued ‘on behalf of’ a political subdivision, provided each of the following requirements is met:

- the corporation must engage in activities that are essentially public in nature;
- the corporation must be one that is created under the state’s general non-profit corporation law (and is not organized for profit except to the extent of retiring indebtedness);
- the corporate income must not inure to any private person;
- the state or political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding;
- the state or political subdivision must obtain legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; AND
- the state or political subdivision must approve both the creation of the corporation and the specific obligations to be issued by the corporation.

Rev. Rul. 63-20 is included in your Deskbook.

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On Behalf of Issuers, Continued

**Intent of
Operating
Rules**

Rev. Proc. 82-26, 1982-1 C.B. 476, gives examples of circumstances in which the criteria of Rev. Rul. 63-20, 1963-1 C.B. 24, will be met for purposes of obtaining an advance ruling (that obligations will be considered obligations of a state or a political subdivision) from the Service.

Section 2 of Rev. Proc. 82-26 provides as follows:

The operating rules of this revenue procedure are intended only to assist issuers of governmental obligations, and other parties with a material financial interest, in preparing ruling requests. The operating rules do not define, as a matter of law, the circumstances under which obligations to be issued by a nonprofit corporation will be considered issued on behalf of a governmental unit within the meaning of section 1.103-1(b) of the regulations. Thus, the operating rules are not to be used as tests for determining the taxability of bond interest.

**Guidance v.
Authority**

Although Rev. Proc. 82-26 provides guidance as to the requirements for an “on-behalf of issuer,” in determining whether an issuer qualifies under Rev. Rul. 63-20 and whether the interest on the bonds is excludable from gross income under § 103, the agent should look to, and cite, the requirements under Rev. Rul. 63-20.

Rev. Proc. 82-26 is included in your Deskbook.

Section 4

Other Issuers

Qualified Scholarship Funding Bonds

A qualified scholarship funding bond is treated as a state or local bond. Section 150(d).

To issue qualified scholarship funding bonds, the issuing corporation must satisfy the following criteria:

- (1) The corporation must be a not-for-profit established exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965, and
- (2) The corporation must be organized at the request of the state or one or more political subdivisions thereof and required by corporate charter and bylaws, or required by state law, to devote any income (after payment of expenses, debt service, and the creation of reserves) to purchase additional student loan notes or pay over any income to the United States.

See § 150(d).

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Other Issuers, Continued

Volunteer Fire Department

A bond of a volunteer fire department is treated as a bond of a political subdivision of a state if the following criteria are met.

- (1) The department is a "qualified volunteer fire department" with respect to an area within the jurisdiction of the state.
- (2) Ninety-five percent or more of the net proceeds of the bond issue are used for the acquisition, construction, reconstruction, or improvement of a fire house (including land which is functionally related and subordinate thereto) or fire trucks to be used by such department.
- (3) The qualified volunteer fire department is organized and operated to provide emergency medical services for persons in an area (within the jurisdiction of the political subdivision):
 - that is not provided with any other firefighting service, and
 - is required (by written agreement) by the political subdivision to furnish firefighting services in such area
- (4) The requirements of §§ 147(f) (public approval) and 149(d) (advance refunding) are met.

See § 150(e).

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Other Issuers, Continued

Indian Tribal Governments Treated as States for Certain Purposes

An Indian tribal government shall be treated as a state for purposes of § 103 (relating to state and local bonds) if certain additional requirements are met.

See §§ 7871(a)(4) and (c) for the additional requirements.

Definitions

The term "Indian tribe" means any Indian tribe, band, nation, or other organized group or community that is recognized as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

See § 7871(c)(3)(E)(ii); Rev. Proc. 84-37, 1984-1 C.B. 606 modified by Rev. Proc. 86-17, 1986-1 C.B. 550; and Rev. Proc. 2008-55, 2008-39 I.R.B. 768.

Additional Requirements

See Phase II, Lesson 12 for special provisions relating to bonds issued by Indian tribal governments.

Section 5

Characteristics of Tax-Exempt Debt

**Debt Must Be
Valid Under
State Law**

Interest on the bonds issued by a state or local government is not excludable from gross income under § 103(a) if the bonds are invalid under state law.

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Characteristics of Tax-Exempt Debt, Continued

**Obligation
Must be Debt
Not Equity**

The term “bond” means any obligation. Section 150(a)(1).

“Obligation means any valid evidence of indebtedness under general Federal income tax principles.” Regulations § 1.150-1(b).

“The characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making this determination are:

- (a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonable foreseeable future;
- (b) whether holders of the instruments possess the right to enforce the payment of principal and interest;
- (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors;
- (d) whether the instruments give the holders the right to participate in the management of the issuer;
- (e) whether the issuer is thinly capitalized;
- (f) whether there is identity between holders of the instruments and stockholders of the issuer;

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Characteristics of Tax-Exempt Debt, Continued

**Obligation
Must be Debt
Not Equity**

(g) the label placed upon the instruments by the parties; and

(h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account."

Notice 94-47, 1994-1 C.B. 357.

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Characteristics of Tax-Exempt Debt, Continued

Example	City, a political subdivision of State, issued revenue bonds to finance the construction of a manufacturing facility. The bonds satisfied the requirements for exemption under the applicable section of the Code. Subsequently, the Supreme Court of State held that under state law the bonds were not valid obligations of City because State's voter approval requirement for issuance of bonds had not been satisfied. Because the bonds were not valid obligations of City under state law, the bonds are not the obligation of a state or political subdivision for purposes of § 103(a). Therefore, interest on the bonds is not excludable from gross income. <i>See Rev. Rul. 87-116, 1987-2 CB 44.</i>
Debt Must Be an Exercise of Borrowing Power	In order for an obligation to exist for purposes of § 103, it must be incurred in the exercise of the issuer's borrowing power. <i>See United States Trust Co. v Anderson, 65 F.2d 575 (2nd Cir. 1933).</i>
Example	Taxpayer's property was taken by condemnation. State court awarded taxpayer an amount for the property plus interest. State's obligation to pay compensation for property taken for public purposes arises as a result of the exercise of eminent domain powers, not as a result of, or in the course of, State's exercise of borrowing power. Therefore, interest received by the taxpayer from the State as a result of property condemnation for public purposes is not exempt from income tax as interest on an "obligation" of a State or political subdivision thereof. <i>See Rev. Rul. 72-77, 1972-1 CB 28.</i>

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Characteristics of Tax-Exempt Debt, Continued

Debt Must Result from a Intent to Make a Loan

Interest on an obligation of a State or political subdivision is not excludable from gross income unless money was borrowed for its use with an obligation to repay.

Debt Must Be an Obligation Regardless of the Source of Repayment

A loan will be treated as an "obligation" for purposes of § 103 whether it is a general obligation of the political subdivision secured by its full faith and credit or whether repayment is restricted to revenues generated by the property purchased with the borrowed funds. The fact that the promise to repay bonds issued by a municipality was limited to the revenues to be derived from leasing the property financed with the bond proceeds did not cause interest on the bonds to be includable in gross income. It is not necessary that the obligation be a general one, pledging the general credit of the municipality or the use of its taxing power.

See Rev. Rul. 54-106, 1954-1 C.B. 28.

Substance Controls

The determination of whether a loan is made (whether debt constitutes an obligation) depends on the substance of a transaction rather than its form.

See Notice 94-47, 1994-1 C.B. 357

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Characteristics of Tax-Exempt Debt, Continued

Interest on the Debt Must Be Interest for Federal Tax Purpose

Only “interest” on a municipal bond can be excluded from gross income by a bond purchaser.

The Supreme Court has defined interest as the amount one has contracted to pay for the use of borrowed money, and as the compensation paid for the use or forbearance of money.

See *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932) and also Rev. Rul. 69-188, 1969-1 C.B. 54.

Interest does not include separate charges made for investigating the prospective borrower and his security, closing costs of the loan and papers drawn in connection therewith, or fees paid to a third party for servicing and collecting a loan.

See *Rev. Rul. 69-188, 1969-1 CB 54*.

Insurance Proceeds as Tax-Exempt Interest

Defaulted interest paid by an independent insurance company pursuant to a bond insurance policy purchased by the issuer (**Rev. Rul. 72-134, 1972-1 C.B. 29**) or the underwriter (**Rev. Rul. 72-575, 1972-1 C.B. 74**) is excludable from the gross income of the bondholders.

Summary

Review

Section 103 provides the foundation for the income exclusion of interest of municipal bonds. Because the exclusion from income is a general provision, the exceptions become much more significant.

Entities that are qualified to issue tax-exempt bonds are:

- states and political subdivisions,
- on behalf of issuers,
- issuers of qualified scholarship funding bonds,
- volunteer fire departments, and
- Indian tribal governments.

In order to be tax-exempt, the debt must possess certain characteristics. The debt must:

- be valid under state law,
- be an exercise of borrowing power.
- result from an intent to make a loan,
- be an obligation regardless of the source of repayment, and
- interest on the debt must be interest for federal tax purposes

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Summary, Continued

Preview of Text The remainder of this text builds on the concepts presented in your orientation and Lessons 2 and 3.

You will learn:

- the provisions of § 149, and how they apply to all types of bonds,
 - how to identify a private activity bond,
 - the requirements of qualified private activity bonds,
 - the applicable rules when a change of use occurs,
 - other requirements applicable only to certain types of qualified private activity bonds,
 - how to compute bond yield and determine if the yield on the investments is materially higher than the bond yield
 - exceptions to yield restriction,
 - rebate requirements and exceptions, and
 - auditing techniques.
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