

# Module B

## Introduction to Federal Taxation of Municipal Bonds

### Overview

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**Introduction** This module provides an introduction to federal taxation of municipal bonds. It focuses on IRC § 103 and its relationship with sections 141-150. It will give you a map for your audit plan, and also provide an overview of the entire course.

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- Objectives** At the end of this module, the student will be able to:
- Explain the provisions of IRC § 103.
  - Differentiate between a governmental and a private activity bond.
  - Define a qualified private activity bond.
  - Define arbitrage.
  - Determine if the entity that issued the bonds is a valid issuer.
  - Determine if the obligation is a valid debt of the issuer.
  - Identify the provisions of IRC § 149.
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## Overview, Continued

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**IRC section 103** When considering whether or not the interest on a municipal bond is taxable or tax-exempt, the starting point is IRC § 103.

IRC § 103 consists of three main provisions:

- 1) IRC § 103(a) generally provides that the interest on state and local bonds will not be included in the gross income of the recipient, AS LONG AS THE BONDS ARE NOT IDENTIFIED IN IRC § 103(b).
  - 2) IRC § 103(b), identifies those types of bonds the interest on which WILL BE TAXABLE to the recipients.
  - 3) IRC § 103(c) provides definitions of:
    - *state or local bonds*, and
    - *state*.
  - 4) Although IRC section 103 discusses “obligations,” neither the Code nor the Regulations define the term. The definition has been defined by various revenue rulings.
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**Importance of  
IRC § 103(b)**

The provisions of IRC § 103(b) are most important because if the bond is described in this section, then the interest is NOT tax-exempt. IRC § 103(b) includes the following types of bonds:

- Private activity bonds - as described in IRC § 141 - which are NOT qualified bonds.
  - Arbitrage bonds - as described in IRC § 148.
  - Bonds that do NOT meet all of the requirements of IRC § 149.
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# Section 1

## IRC section 103(b)

### Overview

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**Introduction** IRC section 103(a) provides that interest paid on state and local obligations will not be taxable to the recipient. Section 103(b) provides certain exclusions to that rule. This section explains those exclusions as well as the difference between governmental and private activity bonds.

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## Governmental Bonds

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### **Governmental Bonds vs. Private Activity Bonds**

IRC section 103(b)(1) provides that private activity bonds are not tax exempt bonds. Therefore, we must be able to identify a private activity bond. To do that, we must be able to distinguish between a private activity bond and a governmental bond.

Distinguishing between the two is important for the following reasons:

- interest on governmental bonds is tax-exempt, while the interest on private activity bonds **GENERALLY** is not.
- some rules apply only to governmental bonds, while others apply only to private activity bonds. Others apply to all bonds, regardless of the type.

For example, the rules of IRC §§ 146 and 147 (Modules J and K) apply only to certain private activity bonds, while the rules of IRC § 149 (Module C) apply to **ALL** bonds.

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### **Governmental Bonds**

Governmental bonds are obligations issued by a governmental unit (or other entity) to finance governmental operations. A local government issues these bonds for its own purposes. For example, a county can issue bonds and expect to use the proceeds to:

- build or renovate a building which the county itself will use,
- build, repair and/or maintain schools and roads,
- build and operate a county-owned power plant or sewage treatment facility.

Two distinguishing characteristics of governmental bonds are that the bond proceeds:

- will be **USED** by the governmental entity for its own purposes, and
  - the bond-financed property will be **OWNED** by the governmental unit.
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### **Where is the Definition of Governmental Bonds?**

Treas. Reg. section 1.150-1(b) defines a governmental bond as any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

IRC § 103 does not mention governmental bonds, but it does refer to private activity bonds. The tests of section 141 are used to distinguish between governmental and private activity bonds.

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## Private Activity Bonds

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- Private Activity Bonds** Generally, private activity bonds are bonds issued by a governmental unit (or related entity):
- the proceeds of which will be used by an entity OTHER THAN a governmental unit, AND
  - the debt service of which will be paid from private payments.

For example, a for-profit hospital system may approach a municipality about issuing bonds because the system wants to construct a new wing. The municipality would issue the bonds, and loan the proceeds to the system. The system would use the proceeds to construct the wing, and repay the loan from hospital income. Assuming that these bonds would not meet any of the sections that provide for *qualified private activity bonds*, these bonds would be private activity bonds, and the interest would be taxable. (Qualified private activity bonds are a specific type of private activity bond which will be discussed shortly.)

Sometimes private use and payment are not obvious. For example, a municipality may issue bonds to finance a government office building, and then meet the tests through an operating or lease agreement with a private party.

A bond cannot be a governmental bond and a private activity bond at the same time.

IRC § 141 provides the tests for private activity bonds. If a bond meets the other requirements, but not the section 141 tests, then it probably is, by default, a governmental bond.

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## Private Activity Bonds, Continued

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### **IRC § 141: Private Activity Bond Tests**

IRC § 141 provides two main tests for private activity bonds. If either test is met, then the bonds are private activity bonds - and the interest on the bonds could be taxable. These tests are:

- private business tests, and
- private loan security or payment test.

If an issue does not meet either of the tests, then it is probably a governmental bond.

These tests will be discussed in more detail in Module D.

Once a bond has been determined to be a private activity bond, there is still a chance that the interest can be tax-exempt. That is, if the bonds meet the requirements of a *qualified private activity bond*.

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## Qualified Private Activity Bonds

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### **Qualified Private Activity Bonds**

Qualified private activity bonds are bonds that are private activity bonds because the tests of IRC § 141 are met. But as long as certain other requirements are met, the interest on the bonds is still tax-exempt. Even though the proceeds of qualified private activity bonds are used by private entities, that use is considered to be a “good” use.

These may be services that municipalities need, but for one reason or another, cannot provide. So, an inducement in the form of tax exempt financing is provided to other entities.

For example, municipalities need hospitals. But few municipalities have the time and expertise to operate a hospital. There are many section 501(c)(3) organizations that know how to operate hospitals, and they could borrow funds from a municipality to construct a hospital. The section 501(c)(3) organization would be providing a community service and lessening the burden of the municipality. These bonds would be considered to be qualified private activity bonds, and the interest would be tax-exempt.

Another example focuses on power plants. Cities need power plants, but some lack resources to operate them. Tax-exempt bond proceeds provide a subsidy to those organizations (whether for-profit or nonprofit) who choose to provide these services.

Qualified private activity bonds also include those issued for “exempt facilities” such as airports, docks, wharves, and mass commuting systems, as well as water, sewage, and solid waste disposal facilities. Qualified private activity bonds can also be issued for residential mortgages, small industrial development projects, student loans, public educational facilities, redevelopment projects, and charitable purposes.

IRC §§ 142 through 145 provide for various types of qualified private activity bonds. Qualified private activity bonds are discussed in Modules E through I. Additional requirements for qualified private activity bonds are discussed in Modules J and K.

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## Qualified Private Activity Bonds, Continued

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### **Change in Use After Issuance**

The tests of IRC § 141 begin on the date of issuance of the bonds, and must be continually applied as long as the bonds are outstanding. For example, the tests are applied when bond-financed property experiences a change in use or ownership sometime after issuance.

When a change in use of bond-financed property occurs after the issuance date - but while the bonds are still outstanding - this change can sometimes affect the tax status of the interest on the bonds causing the interest to become taxable retroactively to the issuance date.

The ramifications of these changes in use are discussed in Module L. These rules are particularly important to examination agents because agents will be verifying the status of the bonds long after the issuance date. Part of the audit plan will be to verify that the bonds are still being used for their intended purpose.

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# Arbitrage Bonds

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**Introduction to Arbitrage** You will recall from reading IRC § 103(b) that the interest on a municipal bond cannot be tax-exempt if the bond is an arbitrage bond.

Although ALL types of bonds are subject to the arbitrage restrictions, different rules apply to the various types of bonds.

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**Definition of Arbitrage** Arbitrage is the purchase and sale of the same or equivalent security in order to profit from price differences. The term arbitrage is not exclusive to municipal securities; it applies to all types of investments.

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**Example** *Continued on next page*  
Suppose City A has an excellent credit rating and can borrow \$1,000 on the tax-exempt market for three years at 6% interest. If marginal tax rates are 25%, this obligation would provide equivalent after-tax income as a similar taxable obligation that bears 8% interest. City A decides to invest the \$1,000 that it borrowed by purchasing an equivalent taxable note bearing 8% interest issued by a corporation that also has an excellent credit rating. Each year, City A receives \$80 and pays only \$60 allowing for \$20 profit. Because City A is not subject to federal income tax, it can keep the entire \$20 each year.

This *tax arbitrage* arises from the effect of the interest exclusion under IRC § 103, which causes a difference between the taxable and tax-exempt markets.

This type of investment activity is precisely what IRC § 148 prohibits.

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**Example** Suppose a farmer sells corn in Village A for \$5 per bushel. A restaurant owner in City B, located 50 miles away from Village A, buys corn in City B for \$10 a bushel. A trucker is willing to transport corn from Village A to City B for \$3 a bushel.

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## Arbitrage Bonds, Continued

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**Example**  
(continued)

If you simultaneously enter into contracts to:

- buy corn from the farmer for \$5,
- sell the corn to the restaurant owner for \$10, AND
- to transport the corn for \$3

you would realize a \$2 profit on each bushel.

That \$2 profit is called *arbitrage*, which in this case arises from the difference between two geographically separate markets.

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**IRC § 148**

The arbitrage rules have two main parts:

- restriction of investment of bond proceeds at a yield that is “materially higher” than the bond yield, (“yield restriction”) AND
- rebate to the federal government of any arbitrage profits that are earned (“rebate”).

The yield restriction basic rule is set forth in section 148(a) where arbitrage bonds are defined as any bonds issued which are reasonably expected to be used to:

- acquire higher yielding investments, OR
- replace funds that were used to acquire higher yielding investments.

The rebate requirement is provided in section 148(f) which provides that whenever certain bond proceeds are invested at a yield above the bond yield, these earnings must be paid (“rebated”) to the United States.

The yield restriction rules are based on “reasonable expectations” on the issuance date, while the rebate requirement is based on actual investment. Therefore, some proceeds may not be subject to yield restriction, but still be subject to the rebate requirements.

As you can guess, both parts have many complex rules and exceptions.

Module M provides a more detailed discussion of arbitrage, while Module N covers rebate requirements.

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## Requirements of IRC § 149

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### **Introduction**

IRC § 103(b)(3) states that the interest on bonds which do not meet the applicable requirements of section 149 will be taxable. Therefore, ALL types of bonds are subject to these rules, although some rules may have limited applicability.

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### **Provisions of IRC § 149**

IRC § 149 contains the following provisions regarding tax-exempt bonds:

- registration
- federal guarantees
- treatment of bonds receiving their tax-exempt status from statutes other than the Internal Revenue Code
- advance refunding
- reporting requirements
- pooled financing
- hedge bonds.

All of these provisions are discussed in Module C. Additionally, Phase II of this training contains more information about the following topics:

- advance refunding
  - pooled financing
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## Section 2

### Issuers Qualified to Issue Bonds

#### Overview

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##### Interest Exclusion

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

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

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

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

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##### State or Local Bond

"**State or local bond**" means an obligation of a State or **political subdivision** thereof. The term "governmental unit" does not include the United States or any agency or instrumentality thereof.

See IRC § 150(a)(2).

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##### District of Columbia

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**."

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## Political Subdivisions

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**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 Treas. Reg. section 1.103-1(b).

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**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.

See Rev. Rul. 61-18, 1961-1 C.B. 5.

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**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*, 666 F.2d 834 (1981). 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.

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## Political Subdivisions, Continued

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### 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*, 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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### 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*, supra, 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 PLR 8119061.) However, where an 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.

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### Special Assessment Districts

Special assessment districts such as road, water, sewer, gas, light reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit may or may not be political subdivisions. The determination must be made whether the district has been delegated sufficient sovereign powers.

See Treas. Reg. section 1.103-1(b).

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## On Behalf of Issuers

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### General Rule

An entity that fails to qualify as a political subdivision may be able to issue tax-exempt bonds "on behalf of" a political subdivision as a "constituted authority" or as a "63-20 corporation". See Rev. Rul. 63-20, 1963-1 C.B. 24, and Rev. Proc. 82-26, 1982-1 C.B. 114. Property is treated as owned by a governmental unit if it is owned on behalf of such unit. See IRC § 150(a)(5).

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

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### “Constituted Authorities”

Constituted authorities can issue tax-exempt bonds **on behalf of** a state or local government if the following criteria are met:

- (1) the authority is a public benefit corporation organized under state law by a municipality;
- (2) the issuance of bonds must be authorized by a specific state statute;
- (3) the bond issuance must have a public purpose (which includes promotion of trade, industry, economic development);
- (4) the governing body of the authority must be controlled by the political subdivision;
- (5) the authority must have the power to acquire, lease, and sell property and issue bonds in furtherance of its purposes;
- (6) earnings cannot inure to the benefit of private persons; AND
- (7) upon dissolution, title to all bond-financed property must revert to the political subdivision.

See Rev. Rul. 57-187, 1957-1 C.B. 65 and Rev. Rul. 60-248, 1960-2 C.B. 35. See PLR 200307004.

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## On Behalf of Issuers, Continued

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### **“63-20 Corporations”**

"63-20 corporations" are formed under state nonprofit law for purposes of issuing obligations **on behalf of** a political subdivision. Rev. Proc. 82-26, 1982-1 C.B. 476, gives examples of circumstances in which the five 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. All of the following criteria must be met:

- (1) the corporation must engage in activities which are essentially public in nature;
- (2) the corporation must be one which is created under the state's general non-profit corporation law (and is not organized for profit except to the extent of retiring indebtedness);
- (3) the corporate income must not inure to any private person;
- (4) the state or political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain bill legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; AND
- (5) the corporation must have been approved by the state or political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.

Rev. Rul. 63-20, 1963-1 C.B. 24 is included in your Deskbook.

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### **Distinguishing between Rev. Rul. 63-20 and Rev. Rul. 57-187**

An entity created under Rev. Rul. 57-187 is distinguishable from an entity created under Rev. Rul. 63-20. Rev. Rul. 57-187 holds that interest on bonds issued by a public corporation or corporate governmental agency organized pursuant to a special state statute providing for the creation of such corporations for the particular purpose specified therein and authorizing such corporations to issue bonds to enable them to carry out the specified purpose, is excludable from gross income under section 103 of the Code. Whereas, Rev. Rul. 63-20 provides that the corporation in question is not a public corporation or corporate governmental agency organized under such a special state statute; it is a private corporation organized under the general nonprofit law of the state.

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## On Behalf of Issuers, Continued

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### **Beneficial Interest**

Rev. Proc. 82-26, 1982-1 C.B. 476, provides the circumstances under which the Service will issue an advance ruling that obligations issued by a non-profit corporation meet the requirements in Rev. Rul. 63-20. Rev. Proc. 82-26 provides that a state or political subdivision will have a beneficial interest in the "63-20 corporation" while the bonds are outstanding and obtain full legal title if (among other things):

- there is no agreement or obligation to transfer title to a third person within 90 days after the obligations are defeased,
- the financed property must retain at least 20 percent of its original value financed with the obligations, AND
- the financed property must retain at least 20 percent of its useful life on the latest maturity date of the obligations.

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.

Accordingly, 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 section 103, the agent should look to, and cite, the requirements under Rev. Rul. 63-20.

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

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## Other Issuers

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### **Qualified Scholarship Bonds**

A qualified scholarship funding bond is treated as a State or local bond. To issue qualified scholarship funding bond(s) 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 IRC § 150(d).

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### **Volunteer Fire Department**

A volunteer fire department is treated as a political subdivision of a state if the following criteria are met. See IRC § 150(e).

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):
    - which 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 IRC §§ 147(f) (public approval) and 149(d) (advance refunding) are met.
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## Other Issuers, Continued

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**Indian Tribal Governments Treated as States for Certain Purposes**

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

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

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**Definitions**

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

See IRC § 7871(c)(3)(E)(ii) and Rev. Proc. 83-87, 1983-2 C.B. 606 modified by Rev. Proc. 86-17, 1986-1 C.B. 550.

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**Additional Requirements**

Substantially all (95 percent) of the bond proceeds must be used to finance "essential governmental functions." Examples are schools, roads, government buildings, etc.

See Treas. Reg. section 1.141-5(d)(4).

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**Manufacturing Facilities**

Indian tribal governments cannot issue tax-exempt private activity bonds. However, they can issue bonds to finance manufacturing facilities located on Indian lands that are owned and operated by the Indian tribes and meet certain employment requirements.

See IRC § 7871(c)(3).

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## Section 3

### Characteristics of Tax-Exempt Debt

#### Overview

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**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 IRC § 103(a) if, subsequent to the issuance, the bonds are determined to be invalid under state law.

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**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 IRC § 144(a)(4). 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 IRC § 103(a). Therefore, interest on the bonds is not excludable from gross income. See Rev. Rul. 87-116, 1987-2 CB 44.

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**Debt Must Be an Exercise of Borrowing Power**

In order for an obligation to exist for purposes of IRC § 103, it must be incurred in the exercise of the issuer's borrowing power. See *United States Trust Co. v Anderson*, 65 F.2d 575 (2<sup>nd</sup> cir. 1933).

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**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, 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. See Rev. Rul. 72-77, 1972-1 CB 28.

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## Characteristics of Tax-Exempt Debt, Continued

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**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.

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**Example**

Political subdivision proposed to issue bonds to finance the acquisition of land for construction of a dam. Property owners selling land may receive cash or negotiable warrants bearing interest at the current market rate. At the same time warrants are issued, the political subdivision will deposit bond proceeds equal to the face amount of the warrants issued to a special escrow (trust) account in a bank. Interest paid on the amounts placed in the special escrow account will be used to pay interest due on the warrants and the administrative costs. The holder of the warrant is entitled to receive the face amount of the warrant upon maturity plus annual interest. The political subdivision has made an immediate and full payment. Payment of principal and interest will be made from the amount deposited in the special escrow account and the earnings of such account. The political subdivision will not be liable for the warrants. Therefore, interest on the warrants to be issued by the political subdivision in exchange for land will not be excludable from the gross income of the holders of the warrants.

See Rev Rul. 74-113, 1974-1 C.B. 31

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**Debt Must Be an Obligation Regardless of the Source of Repayment**

A loan will be treated as an "obligation" for purposes of IRC § 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.

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## Characteristics of Tax-Exempt Debt, Continued

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### 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 Treas. Reg. § 1.141-5(c)(1).

A lease or other contractual arrangement (for example, a management contract or an output contract) may in substance constitute a loan (debt) if the arrangement transfers tax ownership of the facility to a nongovernmental person.

See Treas. Reg. § 1.141-5(c)(1).

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### Interest on the Debt Must Be Interest for Federal Tax Purposes

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.

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### 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.

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## Characteristics of Tax-Exempt Debt, Continued

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### Example

In Rev. Rul. 94-42, 1994-2 C.B. 15, County issued zero coupon bonds with a 30-year maturity payable solely from revenues. One year later, the holder of the bonds purchased insurance sufficient to pay all scheduled debt service on the bonds. At that time, there was significant risk that revenues from the bond-financed facility would be insufficient to pay debt service. The insurer purchased treasury obligations sufficient to pay all the debt service on the bonds. The holder of the bonds then sold the bonds at a profit. The Service found that amounts paid or accrued under an agreement for defaulted interest are not excludable from gross income if the agreement is not incidental or is in substance a separate debt instrument or similar investment when purchased.

A bond insurance policy is treated as both incidental and not a separate debt instrument or similar investment if, at the time it is purchased:

- the amount paid to obtain it is reasonable,
- the purchase is customary, and
- it is consistent with the expectation that the issuer of the bonds, rather than the insurer, will pay debt service on the bonds.

The result is the same regardless of whether the holder acquired the bonds at original issuance or on the secondary market.

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# Auditing Techniques

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## Introduction

The examination of a tax-exempt bond issue is very similar to the examination of a tax-exempt organization. Both types of examinations require the examiner to:

- verify qualifications for continued tax-exemption, AND
- determine if there is any tax liability associated with the bonds.

Although the examination processes are similar, there are some differences, such as:

- the issuer of the bonds must be a governmental unit. As such it does not file tax returns to pay or pay income taxes. Nevertheless it is treated as a taxpayer for purposes of the Code
  - although initial contact is made with the issuer, the issuer is often NOT the taxpayer involved in the transaction. Often the issuer loans the bond proceeds to another taxpayer called the conduit borrower
  - often the issuer does not maintain the records pertinent to the examination; these must be obtained from the conduit borrower
  - bond examinations possess special disclosure concerns
  - special closing procedures are used for bond examinations
  - there is more extensive involvement of National Office and District Counsel staff
  - there is more potential for use of a summons to obtain information.
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## Bond Information Return

When you are assigned a bond issue for examination, you should receive a Form 8038 series report. This information return is filed by the issuer on or shortly after the issuance date of the bonds. It will tell you basic information about the issue, including the type of bond. If the issue was classified as a qualified private activity bond, the form will indicate the Code section under which the issue was classified. Your goal during the examination is to verify that the bonds should continue to maintain this classification. If not, you must determine whether the interest on the bonds remains tax-exempt. **(See Forms 8038 and 8038-G and instructions.)**

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## Integration of Audit Techniques

Throughout the course, appropriate audit techniques are introduced and discussed.

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## Summary of Module B

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### Review of Module B

IRC § 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 which are qualified to issue tax-exempt bonds are:

- political subdivisions, AND
- on behalf of issuers.

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
- be interest for federal tax purposes.

Recall that section 103(b) provides that the interest on certain bonds will be taxable. These exclusions are:

- private activity bonds that are not qualified,
- arbitrage bonds, AND
- those bonds that do NOT meet the applicable section 149 requirements.

Module B introduced each of these concepts by discussing the following:

- governmental bonds, private activity bonds, and qualified private activity bonds,
- yield restriction and rebate are the two main parts of the arbitrage rules, AND
- the provisions of section 149.

ALL of these concepts will be discussed in greater detail later in the text.

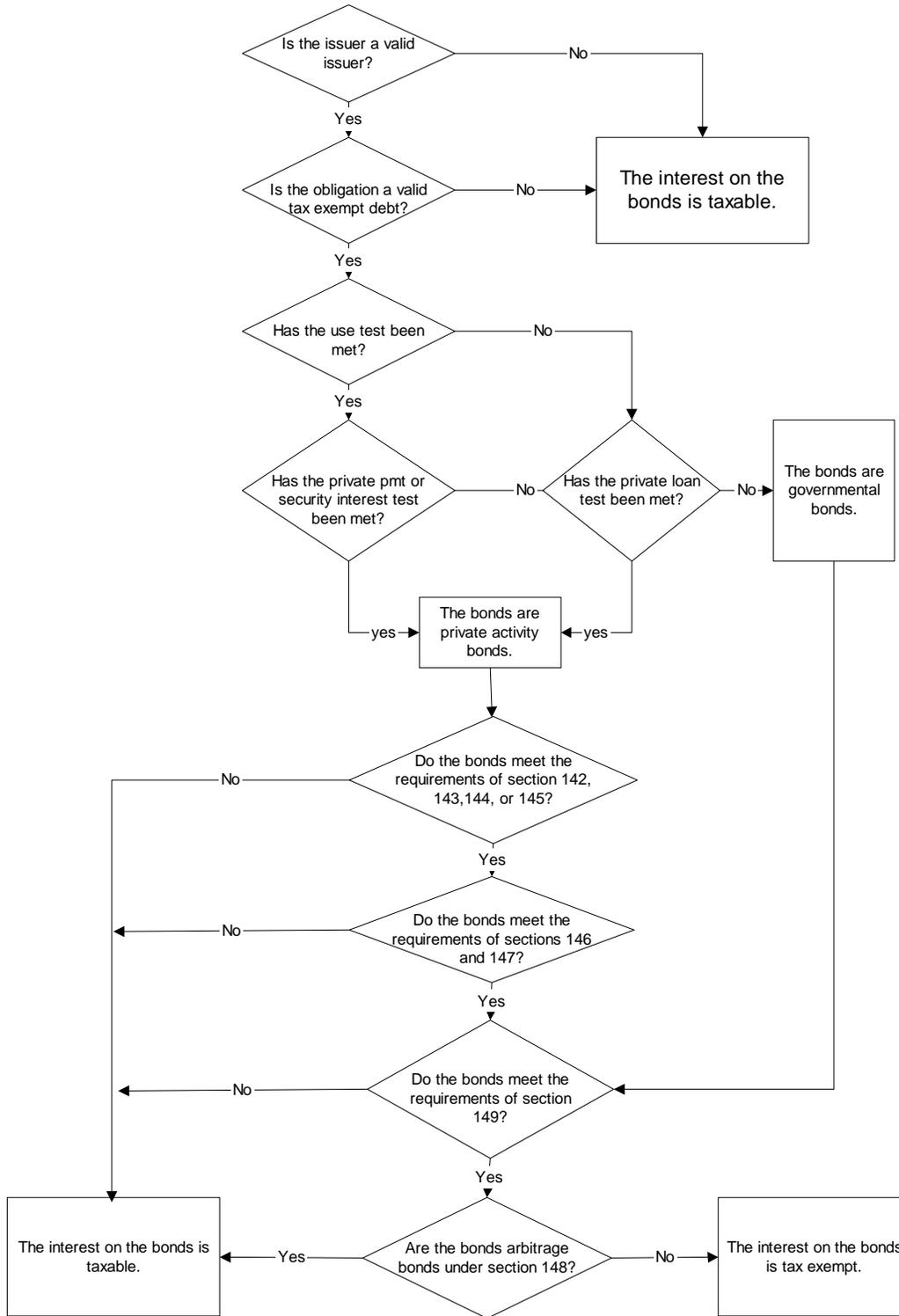
**Figure B-1** illustrates the concepts discussed in Module B, as well as some of the decisions which must be made regarding bond issues. Note that this is a very general guide, and is NOT inclusive enough to be used as an audit plan.

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# Summary of Module B, Continued

FIGURE B-1: GENERAL PROVISIONS OF IRC SECTION 103



## Summary of Module B, Continued

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### Preview of Text

The remainder of this text builds on the concepts presented in Modules A and B. The text concentrates on the three exceptions of section 103(b). The terminology and techniques presented in Module A will be used throughout the text.

You will learn:

- the provisions of section 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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## Class Exercises

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**Exercise 1** IRC § 103(a) provides a general exclusion from gross income for the interest on state and local bonds.

What three are the three exclusions from tax exemption as provided by IRC section 103(b)?

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**Exercise 2** Indicate whether the following bond issues issued by City A would be classified as governmental, private activity, or qualified private activity bonds.

- (a) Bond proceeds used to construct a pavilion in City A's park.
- (b) Bond proceeds used by a for-profit entity to provide local electricity.
- (c) Bond proceeds used to renovate a city-owned building, which will be leased to a retail organization.
- (d) Bond proceeds used by a section 501(c)(3) organization to construct an office building to be used as its headquarters.

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## **Class Exercises, Continued**

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**Exercise 3**      What are the two main parts of the arbitrage rules?

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**Exercise 4**      You are assigned the examination of Bond Issue 1 issued by County A. The Form 8038-G indicates that the bonds are governmental bonds. Indicate whether or not the following procedures should be included in your audit plan:

- (a) Private activity bond tests of IRC § 141
  - (b) Compliance with IRC § 149
  - (c) Compliance with IRC § 146
  - (d) Compliance with IRC § 147
  - (e) Analysis of invested proceeds to determine the yield.
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