

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

June 8, 2000

LEGEND:

Authority =
Trustee =
State =
Bonds =
Date 1 =

Dear:

This letter is in reply to your request for a ruling waiving the failure-to-pay penalty described in § 148(f)(4)(C)(x) of the Internal Revenue Code.

Facts and Representations

You make the following factual representations. The Authority is a public corporation organized under the laws of the State. On Date 1 the Authority issued the Bonds for the purpose of financing certain capital improvements to a waterworks plant and distribution system. In paragraph (B)(6) of the non-arbitrage certificate, executed by the Authority in connection with the issuance of the Bonds, the Authority elected to pay, in lieu of rebate, the penalty specified in former § 148(f)(4)(B)(iv). Trustee was engaged as the trustee of the Bond issue. The Bond documents provide that the Trustee had the obligation to report and pay on behalf of the Authority amounts due under § 148 of the Code.

The Authority did not meet the spending requirements imposed by former § 148(f)(4)(B)(iv). In late 1998, the Trustee discovered that the Bond documents contained covenants making the Trustee responsible for complying with the arbitrage rules in § 148. It was not customary for the Trustee to assume such responsibilities. Upon making this discovery in late 1998, the Trustee determined that neither it nor the Authority had monitored tax compliance for the Bonds since the Bonds were issued on Date 1. There are no facts that indicate a report about the Bond proceeds from the Trustee was sent to Authority during the 8 ½ years. There are also no facts that indicate Authority made any effort to contact Trustee about the expenditure and investment of its Bond proceeds during the 8 ½ years. The Authority represents that no

arbitrage was earned on the Bonds, and that it was under the impression that no arbitrage rebate or penalty payments were owed on the Bonds so long as no arbitrage was earned.

Between February of 1999 and August of 1999, the Authority and the Trustee reviewed the Bond documents and the transactions affecting the Bonds since Date 1. Also during this period, legal research was done to determine whether any penalty-in-lieu-of rebate payment was owed on the Bonds. During the summer of 1999, legal counsel concluded that the failure to pay penalty described in § 148(f)(4)(C)(x) and the penalty-in-lieu-of rebate were likely owed on the Bonds. In August of 1999, the Authority and the Trustee decided to seek a private letter ruling from the Service waiving the failure to pay penalty. In January of 2000, the Authority submitted to the Service a request for a ruling waiving the failure to pay penalty. In April of 2000, or approximately 1-1/2 years after the failure to pay the penalty was discovered, the Authority paid \$a, which the Authority had calculated as the amount of the penalty-in-lieu-of rebate, plus interest, that was owed on the Bonds. The Authority did not make the payment of \$a until requested to do so by the IRS.

The Authority requests a ruling from the IRS waiving the § 148(f)(4)(C)(x) failure to pay penalty as it applies to the Bonds.

Law and Analysis

Section 103(a) excludes from gross income interest on any State or local bond. Under § 103(b)(2), however, the exclusion under § 103(a) does not apply to any arbitrage bond.

Section 148(a) defines the term “arbitrage bond” as 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 bonds, to be used directly or indirectly (1) to acquire higher yielding investments or (2) to replace funds that were used directly or indirectly to acquire higher yielding investments.

Under § 148(f), a bond that is part of an issue is treated as an arbitrage bond unless rebate is paid to the United States by the issuer in a timely manner. The amount that must be paid is equal to the excess of the amount earned on all nonpurpose investments over the amount that would have been earned if the nonpurpose investments were invested at a rate equal to the yield on the issue.

Section 7652(b) of the Omnibus Budget Reconciliation Act of 1989 (the “1989 Act”) added to the Code former § 148(f)(4)(B)(iv), which provided an exception to the rebate requirement for construction issues. Within the provisions of this exception, the 1989 Act allowed issuers to elect to satisfy the rebate requirement by paying a penalty.

Section 11701(j) of the Omnibus Reconciliation Act of 1990 provided technical corrections to former section 148(f)(4)(B)(iv). The corrected provisions are now found in § 148(f)(4)(C) and continue to provide an exception to the rebate requirement for construction issues. Section 148(f)(4)(C) is effective as of December 19, 1989, the effective date of the 1989 Act.

Section 148(f)(4)(C)(vii) allows the issuer to avoid the application of the rebate requirement of § 148(f)(2) by electing to pay a penalty (the “penalty-in-lieu-of rebate”) for each 6-month period equal to 1-1/2 percent of the amount of available construction proceeds of the issue that are not spent as required at the end of that period.

Section 148(f)(4)(C)(x) provides that if an issuer fails to pay the in-lieu-of penalty in a timely manner and the failure is not caused by willful neglect, the Secretary may treat the failure as not having occurred if the issuer pays the penalty-in-lieu-of rebate plus another penalty (the “failure penalty”) equal to 50 percent of the unpaid penalty-in-lieu-of rebate plus interest at the underpayment rate on the unpaid penalty-in-lieu-of rebate amount. Section 148(f)(4)(C)(x) permits the Secretary to waive all or part of the failure penalty. Failure to timely pay the amount required to correct the failure results in the retroactive loss of the issue’s tax-exempt status.

Thus, the failure penalty contained in § 148(f)(4)(C)(x) plus interest applies unless the Secretary determines that it should be waived, in whole or in part. Waiver of all or part of the failure penalty is determined based on the facts and circumstances of the particular case. Factors that may be taken into account to determine if all or part of the failure penalty may be waived include: the sophistication of the issuer, the steps taken to comply, and the length of delay.

Here, the Authority’s failure to pay the penalty-in-lieu-of rebate was not discovered for approximately 8-1/2 years after the issue date of the Bonds, and the penalty-in-lieu-of rebate, plus interest, was not paid for another approximately 1-1/2 years after the discovery. The payment of \$a was made only after it was requested by the IRS. During the 1-1/2 year period, legal research was done regarding whether the penalty-in-lieu-of rebate was owed. There is no evidence that during the 8-1/2 year period the Authority made any attempt to determine their liability under § 148, or otherwise contacted or monitored in any way the Trustee to ensure that it was tracking the Bonds’ continuing compliance with § 148. However, (1) the Authority appears to be relatively unsophisticated in tax-exempt bond matters, and (2) the Authority represents that it was under the mistaken impression that no arbitrage rebate or penalty payments were owed on the Bonds so long as no arbitrage was earned.

We are of the opinion that the duty to comply with § 148 cannot be delegated to another entity such as the Trustee without at least minimum efforts to insure that the delegate is meeting its obligations. The total lack of contact with Trustee during the 8 ½ year period in this case is at a minimum negligent, although we do not believe that it

risers to the level of willful neglect given the level of sophistication of the Authority.

The additional time of approximately 1 ½ years to make the penalty-in-lieu-of-rebate payments after the problem was discovered also is of concern. Despite the fact that § 148(f)(4)(C)(vii) clearly retroactively applied to the Bonds, payment was not made until it was requested by the IRS. This delay was primarily the responsibility of legal counsel hired to advise the Authority about its options after the discovery by the Trustee. Nevertheless, the Authority had a duty to ensure that it received a timely answer to its questions about the penalty-in-lieu-of rebate payment for which it was ultimately responsible. We believe that the Authority's willingness to wait for 1 ½ years for an answer to this question is negligent but not willful neglect.

For the same reasons that we have concluded that the Authority did not willfully neglect its responsibility to pay the penalty-in-lieu-of rebate with respect to the Bonds, we are willing to waive part of the Authority's failure penalty under § 148(f)(4)(C)(x). We also note that the Authority did not ignore the problem of the unpaid penalty-in-lieu-of rebate after the problem was discovered. Based on these factors, we have determined that the Authority should pay no more than 60 percent of the failure penalty.

Conclusion

Based on the circumstances of this particular case, we conclude that the Authority's failure to pay the penalty-in-lieu-of rebate was not due to willful neglect. Forty percent of the failure penalty is waived. The Authority must pay the remainder of the failure penalty within 45 days after receipt of this letter.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a Power of Attorney on file with this office a copy of this letter is being sent to the Authority's authorized representative.

Sincerely yours,
Assistant Chief Counsel
(Tax Exempt and Government Entities)
By: Timothy L. Jones
Assistant to the Chief
Tax Exempt Bond Branch