INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director
Key District

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Authority

University

Bonds

Swap Agreements

Date 1

Date 2

Date 3

Date 4

Year 1

Year 2

Unless otherwise noted, all references to the Income Tax Regulations are to the regulations published as T.D. 8476, 1993-2 C.B. 13 (the “1993 Regulations”).

ISSUES:

(1) Whether the Swap Agreements constitute a qualified hedge under § 1.148-4(h)(2) with respect to the Bonds?

(2) Whether the actual amount of rebate payments with respect to the Bonds may be future valued for purposes of determining the amount of a rebate overpayment under § 1.148-3(i)(1)?

CONCLUSIONS:

(1) The Swap Agreements do not constitute a qualified hedge under § 1.148-4(h)(2). However, under the circumstances presented here, it is appropriate to apply § 1.148-4(h)(5)(iii) and, therefore, to recompute the yield on the Bonds taking into account the payments under the Swap Agreements from the dates the University entered into the Swap Agreements until the date the Bonds were redeemed (the “Hedging Period”).

(2) The actual amount of rebate payments with respect to the Bonds may not be future valued for purposes of determining the amount of a rebate overpayment under § 1.148-3(i)(1).

FACTS:

The Authority issued the Bonds on Date 1 and loaned the proceeds to the University. The Bonds were scheduled to mature after Year 2. During the Hedging Period, interest was payable on the Bonds on the first day of each calendar month. During the Hedging Period, the interest rate on the Bonds was the interest rate, reset each business day, that would be necessary to remarket the Bonds at a price of par on that particular business day *(i.e.*, a daily rate). The University made debt service payments on the Bonds from its general revenues.

On the Date 3, the Authority issued tax-exempt bonds (the “Refunding Bonds”) to refund the Bonds.

The University entered into the Swap Agreements in Year 1 (prior to the promulgation of the 1993 Regulations) in order to reduce its exposure to interest rate changes with respect to the Bonds and with respect to two additional tax-exempt variable rate bond issues (the “Additional Bonds”). We subsequently refer to the Bonds and the Additional

Bonds, collectively, as the “Hedged Bonds”. At the time of execution, the Swap Agreements were “on-market” interest rate swaps. The Swap Agreements terminate in Year 2. The University made a payment in the amount of $d to its legal counsel for certain services rendered in connection with the Swap Agreements.

The Swap Agreements provide for quarterly payments. Because the Hedged Bonds consisted of three multi-modal bond issues, it was possible for each issue of the Hedged Bonds to have different interest payment dates depending on the interest rate mode chosen by the University. To reflect the various payment date possibilities, quarterly payments for the Swap Agreements were chosen.

The University made the payments under the Swap Agreements from its general revenues. On each quarterly payment date, the University made fixed-rate payments based on a rate set forth in the Swap Agreements. On each quarterly payment date, the swap providers made variable-rate payments based on the simple weighted average of the weekly computation of the JJ Kenney High Grade 30-Day Municipal Index (now known as the Weekly High Grade Index) (the “Index”) during each quarter. The Index tracks high grade weekly tax-exempt interest rate levels. The Index was chosen by the University as a method of matching the possibly different interest rate modes on each issue of the Hedged Bonds. In fact, during the Hedging Period, the Index did not vary substantially from the interest rate on the Bonds.

For each quarterly period covered by a payment under the Swap Agreements, the University identified the percentage of the interest payments on the Bonds that the Swap Agreements hedged in the following manner (always less than 100 percent):

> (1) The University determined the ratio of the outstanding principal balance of the Bonds to the outstanding principal balance of the Hedged Bonds.
>
> (2) The University determined the notional principal amount of the Swap Agreements that was allocable to the Bonds by multiplying the ratio determined in (1) by the notional principal amount of the Swap Agreements.
>
> (3) The University determined the percentage of the interest payments on the Bonds that were hedged under the Swap Agreements by dividing the notional principal amount of the Swap Agreements allocable to the Bonds, determined in (2), by the outstanding principal amount of the Bonds.

Thus, for example, if the outstanding principal amount of the Bonds as of a payment date was $100, the outstanding principal amount of the Hedged Bonds was $250, and the notional principal amount of the Swap Agreements was $80, then the percentage of each interest payment on the Bonds that was hedged for the applicable quarterly period would be 32% ($100/$250 = 40%; 40% x $80 = $32; and $32/$100 = 32%).

Because of the scheduled principal payments on the outstanding principal amounts of the Hedged Bonds and scheduled reductions in the notional principal amount of the Swap Agreements, the percentage of the interest payments on the Bonds that were hedged varied. Over the term of the Swap Agreements, the total variance was less than 1.5 percentage points. These percentages were fixed and determinable as of the dates the Swap Agreements were executed.

The University contacted the Authority by letter before it entered into the Swap Agreements to request information regarding the costs and benefits of converting the variable interest rates on the Hedged Bonds to fixed interest rates. The letter did not specifically indicate that the University intended to enter into any interest rate swaps with respect to the Bonds. Moreover, although the University identified the Swap Agreements on its books and records, at no time did the Authority identify the Swap Agreements on its books and records. However, the Authority noted the existence of the Swap Agreements on the first Form 8038-T filed with the Internal Revenue Service after the University entered into the Swap Agreements.

The Authority filed its first Form 8038-T and made its first rebate payment for the Bonds on Date 2. At or about the same time, the Authority elected to apply the 1993 Regulations to the Bonds. As a result of the issuance of the Refunding Bonds and the redemption of the Bonds, the Authority filed its final Form 8038-T and made its final rebate payment on Date 4. The computation of these rebate payments did not take into account any payments made or received by the University under the Swap Agreements. On Date 4, the Authority submitted a request for recovery of an overpayment of rebate. The basis for the request was a recomputation of the yield on the Bonds that took into account the payments made or received by the University under the Swap Agreements. The Authority determined the amount of its rebate overpayment for purposes of this request, in part, by future valuing the amount of the first rebate payment to the final computation date for the Bonds.

LAW AND ANALYSIS:

Qualified Hedge

Section 1.148-4(h)(1) provides that payments made or received by an issuer under a qualified hedge (as defined in § 1.148-4(h)(2)) relating to bonds of an issue are taken into account (as provided in § 1.148-4(h)(3)) to determine the yield on that issue. Except as provided in § 1.148-4(h)(4), the issue is treated as a variable yield issue.

A qualified hedge is a contract that satisfies each of the requirements provided at § 1.148-4(h)(2). These requirements are as follows:

Under § 1.148-4(h)(2)(i)(A), the contract must be a hedge entered into primarily to reduce the issuer's risk of interest rate changes with respect to a borrowing. For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.

Under §1.148-1(b), the term issuer generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.

Under § 1.148-4(h)(2)(i)(B), the contract is not a hedge under § 1.148-4(h)(2)(i)(A) if it contains a significant investment element (*i.e.*, an expected return). A contract may contain a significant investment element if the payments under the contract do not correspond closely in time and amount to the interest payments on the bonds being hedged. For example, an interest rate swap generally contains a significant investment element if it requires any payments other than periodic payments, within the meaning of § 446 and the regulations thereunder (periodic payments) (*e.g.*, an up-front payment for an off-market swap) before its termination date. Similarly, an interest rate cap generally contains a significant investment element if the cap rate is less than the on-market swap rate on the date the cap is entered into. For this purpose, the on-market swap rate is the single fixed rate for which the rate or index that is the subject of the cap could be swapped in an on-market interest rate swap that requires only periodic payments and that has a term equal to the term of the cap.

Under § 1.148-4(h)(2)(ii), the contract must be entered into between the issuer or the political subdivision on behalf of which the issuer issues the bonds (collectively referred to in § 1.148-4(h) as the issuer) and a provider that is not a related party (the hedge provider).

Under § 1.148-4(h)(2)(iii), the hedge must cover all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity, and terms). If the hedge does not cover all interest payments on all of the substantially identical bonds being hedged, it must cover, in whole or in part, the same specific identifiable interest payments on each of the substantially identical bonds. Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first five years following their issuance. For purposes of § 1.148-4(h), unless the context clearly requires otherwise, hedged bonds means the specific bonds or portions thereof (*i.e.*, the specific interest payments) covered by a hedge.

Under § 1.148-4(h)(2)(iv), changes in the value of the contract must be based primarily on interest rate changes. For example, an interest rate swap or a futures contract on Treasury securities may qualify. A commodity swap or an option on a commodity futures contract, however, is not a qualified hedge.

Under § 1.148-4(h)(2)(v), the contract may not hedge an amount larger than the issuer's risk with respect to interest rate changes on the hedged bonds.

Under § 1.148-4(h)(2)(vi), the payments to the issuer under the contract must correspond closely, in both time and amount, to the specific interest payments being hedged on the hedged bonds.

Under § 1.148-4(h)(2)(vii), payments may not begin to accrue under the contract on a date earlier than the sale date of the hedged bonds and cannot accrue longer than the hedged interest payments on the hedged bonds.

Under § 1.148-4(h)(2)(viii), payments to the hedge provider must be reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal and interest on the hedged bonds.

Under § 1.148-4(h)(2)(ix), the hedge must be identified by the actual issuer on its books and records maintained for the hedged bonds on or before the later of the date on which the parties enter into the contract or the issue date of the hedged bonds. The identification must specify the hedge provider, the terms of the hedge, and the hedged bonds. The identification must contain sufficient detail to establish that the requirements of § 1.148-4(h)(2) and, if applicable, § 1.148-4(h)(4) are satisfied. The existence of the hedge must be noted on all forms filed with the Internal Revenue Service for the issue after the date on which the hedged is entered into.

Under § 1.148-4(h)(5)(iii), if an issuer enters into a hedge that is not properly identified or otherwise fails to meet the requirements of § 1.148-4, the Commissioner may recompute the yield on the issue taking the hedge into account if the failure to take the hedge into account distorts that yield or otherwise fails to clearly reflect the economic substance of the transaction.

Recovery of Rebate Overpayment

Under § 1.148-3(i)(1), an issuer may recover a rebate overpayment for an issue of tax-exempt bonds by establishing to the satisfaction of the Commissioner that the overpayment occurred. An overpayment is the excess of the amount paid to the United States for an issue under § 148 over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under § 148 as of the date the recovery is requested.

Section 1.148-3(j), Example 2, illustrates the calculation and payment of rebate for a variable yield issue. In the Example, the computation of rebate for the second computation date is made by future valuing any payments previously made to the United States to the second computation date (using the bond yield for the second computation period as the discount rate). In the last part of the Example, a scenario is presented in which the bond yield during the second computation period is higher than the bond yield during the first computation period. The conclusion of the Example for this scenario is that, after future valuing the payment for the first computation period (using the bond yield for the second computation period) to the second computation date, the issuer would have overpaid the rebate amount by a specified amount. This amount was computed by taking the future value of the payment as of the second computation date and subtracting the rebate amount as of that date.

Qualified Hedge Analysis

Applying the § 1.148-4(h)(2) requirements for a qualified hedge to the facts presented, we conclude as follows:

The Swap Agreements satisfy the § 1.148-4(h)(2)(i)(A) requirement for a hedge. The Swap Agreements consist of three interest rate swaps that the University entered into in order to reduce its risk of interest rate changes with respect to the Hedged Bonds, including the Bonds. The use of the term issuer in § 1.148-4(h)(2)(i)(A) includes the University as the conduit borrower of the proceeds of the Bonds because nothing in that provision clearly requires that the term mean the actual issuer rather than the conduit borrower. Moreover, in the context of a conduit financing issue, the conduit borrower is typically the party responsible for debt service, and accordingly, it is the conduit borrower's risk of interest rate changes that would be reduced.

The Swap Agreements satisfy the § 1.148-4(h)(2)(i)(B) requirement that the contract contain no significant investment element. The Swap Agreements were on-market interest rate swaps on their dates of execution. The payment by the University to its legal counsel for certain services rendered with respect to the Swap Agreements in the amount of $d does not alter this result.

The Swap Agreements satisfy the § 1.148-4(h)(4)(2)(ii) requirement that the issuer or a political subdivision on behalf of which the issuer issues the bonds enter into the hedge with a hedge provider that is an unrelated party. Nothing in this provision clearly requires that the term issuer mean the actual issuer rather than the conduit borrower. Moreover, in context, it is not inappropriate that the party whose risk of interest rate changes is being reduced actually enter into the contract. Finally, the University and the swap providers are not related parties as that term is defined at § 1.150-1(b).

The Swap Agreements satisfy the § 1.148-4(h)(2)(iii) requirement that the hedge cover the same specific identifiable interest payments on each of the substantially identical bonds being hedged. The Swap Agreements covered a percentage of each interest payment on the Bonds, rather than all interest payments on the Bonds. That percentage varied less than 1.5 percentage points over the term of the Swap Agreements. These variations were based on scheduled reductions in the total outstanding principal amount of the Hedged Bonds and scheduled reductions in the total outstanding notional principal amount under the Swap Agreements and accordingly, were fixed and determinable as of the execution dates of the Swap

Agreements. For each period covered by a quarterly payment under the Swap Agreements, the applicable percentage of all of the interest payments on the Bonds were hedged.

The Swap Agreements satisfy the §1.148-4(h)(2)(iv) requirement any that changes in the value of the contract must be based primarily on interest rate changes. Under the Swap Agreements, all payments are interest-based, *i.e.*, the University makes periodic payments based on specified fixed interest rates and the swap providers make periodic payments based on the Index.

The Swap Agreements satisfy the § 1.148-4(h)(2)(v) requirement that the contract not hedge an amount larger than the issuer's risk regarding interest rate changes on the hedged bonds. The use of the term issuer includes the University, as the provision does not clearly require otherwise and the context (*i.e.*, the risk regarding interest rate changes) is consistent with applying the rule to the University. For each quarter over the term of the Hedging Period, the Swap Agreements covered less than the total outstanding principal balance of the Bonds and, therefore, did not hedge more than the University's risk regarding interest rate changes on the Bonds.

The Swap Agreements satisfy the § 1.148-4(h)(2)(vi) requirement that payments to the issuer correspond closely in time and amount to the interest payments covered by the hedge. As to the time of payments, under the Swap Agreements, payments were made quarterly; the University's interest payments on the Bonds were due on the first day of each month. The payment dates on the Swap Agreements were set in a manner that would correspond to all of the Hedged Bonds, not just the Bonds. The only objective standard as to timing of payments is set forth at § 1.148-4(h)(4)(i)(C), which generally requires swap payments to be made within 15 days of the related payments on the hedged bonds for purposes of determining if a variable yield issue may be treated as a fixed yield issue. Because of the benefits associated with being treated as a fixed yield issue, this rule sets a higher standard for the timing of payments than for an issue that would continue to be treated as a variable yield issue. Accordingly, for variable yield issues, payments more than 15 days apart may be allowed. Under the facts presented, the quarterly payments on the Swap Agreements correspond closely in time to the monthly payments on the Bonds.

As to the amount of the payments, the basis for determining payments under the Swap Agreements and the basis for determining the interest rate for the Bonds are not identical. The interest rate on the Bonds is reset daily at the rate necessary to remarket the Bonds at a price of par (*i.e.*, a daily rate). The swap providers' payments are based on the simple weighted average of the weekly computation of the Index during each quarter (*i.e.*, a weekly rate). The determination of whether swap payments and interest payments closely correspond should be based on whether, as of the date of execution of the swap, such payments are expected to be substantially similar. In this case, the Index was chosen to match the different interest rate modes on the Hedged Bonds, not just the Bonds. In fact, the Index and the rate on the Bonds did not vary substantially.

Under the facts presented, the swap provider payments correspond closely in amount to the University's interest payments on the Bonds.

The Swap Agreements satisfy the § 1.148-4(h)(2)(vii) requirement as to the timing and duration of payments under the hedge. Payments under the Swap Agreements began in Year 1, approximately 2 years after the sale date of the Bonds. Payments under the Swap Agreements will terminate in Year 2, a date which is before the date that the Bonds were scheduled to mature.

The Swap Agreements satisfy the § 1.148-4(h)(2)(viii) requirement as to the source of payments. The University makes debt service payments on the Bonds and payments under the Swap Agreements from the same source, its general revenues.

The Swap Agreements satisfy the § 1.148-4(h)(ix) identification requirement only in part. The Authority noted the existence of the Swap Agreements on the first Form 8038-T filed with the Internal Revenue Service after the University entered into the Swap Agreements. However, at no time did the Authority identify the Swap Agreements on its books and records. Although the University identified the Swap Agreements on its books and records, § 1.148-4(h)(2)(ix) specifically provides that the actual issuer, not the issuer, must comply with the identification requirement.

The Swap Agreements satisfy all of the requirements of § 1.148-4(h)(2) other than the identification requirement. Thus, the Swap Agreements do not constitute a qualified hedge under § 1.148-4(h)(2). However, under the circumstances presented here, it is appropriate to apply § 1.148-4(h)(5)(iii) and, therefore, to recompute the yield on the Bonds taking into account the payments under the Swap Agreements over the term of the Hedging Period. From the facts, it is clear that the University intended to integrate the allocable portion of the Swap Agreements with the Bonds. This is evidenced, for example, by the fact that the Authority noted the existence of the Swap Agreements on the first Form 8038-T filed with the Internal Revenue Service after the execution of the Swap Agreements. Moreover, at the time the Bonds were issued and the time the Swap Agreements were entered into, the University had reason to believe that the Swap Agreements could be taken into account because the preamble to the regulations in effect (T.D. 8252, 1989-1 C.B. 25, 34) suggested that certain hedging transactions, such as interest rate swaps, should be taken into account in computing the yield on an issue. The Authority's election to apply the 1993 Regulations to the Bonds and the failure to satisfy the identification requirement should not be determinative. The University entered into the Swap Agreements prior to the promulgation of the 1993 Regulations, and it could not have known of the requirement that the actual issuer identify the hedge on its books and records. To not take the payments made or received by the University under the Swap Agreements into account in these circumstances would ignore the economic substance of the transaction.

Rebate Overpayment

For purposes of the Date 2 and Date 4 rebate payments, payments made under the Swap Agreements were not taken into account. The Authority submitted a request for recovery of an overpayment of rebate on Date 4. The Authority determined the amount of its rebate overpayment for purposes of this request by future valuing the first rebate payment actually made to the final computation date for the Bonds.

Section 1.148-3(i)(1) provides that an overpayment is the excess of the amount paid to the United States for an issue under § 148 over the sum of the rebate amount for an issue as of the most recent computation date and all amounts that are otherwise required to be paid under § 148 as of the date the recovery is requested. The regulation does not provide that the amount paid be future valued or that the amount paid is anything other than the amount that is actually paid to the United States.

The Authority argues that § 1.148-3(j), Example 2, in which earlier rebate payments are future valued in determining the rebate amount that an issuer had overpaid, stands for the proposition that an issuer should future value its earlier rebate payments in computing the amount of a rebate overpayment under § 1.148-3(i)(1). We disagree. The Example should be read to be consistent with the plain language of § 1.148-3(i)(1), rather than reading language into that section because of the Example. When the regulations intend for an amount to be future valued, it is explicitly stated and is not left to inference. For example, § 1.148-3(f)(1) explicitly directs issuers to future value previous rebate payments for an issue when computing the amount of a rebate installment payment. Section 1.148-3(i)(1) contains no such language. Moreover, the Issuer's interpretation is inconsistent with that portion of the preamble to the proposed regulations underlying the 1993 regulations relating to the recovery of rebate overpayments. The preamble states that "[t]he proposed regulations do not provide for the payment of interest on overpayment. Specific legislative authorization may be required to pay such interest." 57 Fed. Reg. 53046, 53048 (Nov. 6, 1992). The substantive provision described in the preamble did not change when the regulations were finalized, and we see no reason to interpret the 1993 regulations in a manner that ignores the preamble. Consequently, we conclude that the amount of the rebate overpayment is based on the amount actually paid, not the future value of the amount actually paid.

CAVEAT(S)

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction that is not discussed in this technical advice memorandum. No opinion is expressed regarding whether the interest on the Bonds is exempt under § 103. In addition, no opinion is expressed regarding the application of the § 1.148-4(h)(3) requirements for accounting for qualified hedges.

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.