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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LAURENCE ZIEGLER
AREA COUNSEL CC:TEGE:NEMA:BRK

FROM: Mary E. Oppenheimer
Assistant Chief Counsel CC:TEGE:EOEG

SUBJECT: Window Refunding Transactions

This Chief Counsel Advice responds to your memorandum dated November 23, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

- Issuer =
- System =
- Year 1 =
- Year 2 =
- Year 3 =
- Series 1 Bonds =
- Series 2 Bonds =
- Refunding Bonds =
- a =
- b =
- c =
- d =
- e =
- Date 1 =

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Date 2 =

ISSUES

1. Whether the Refunding Bonds are arbitrage bonds under section 148(a) of the Internal Revenue Code (the "Code") because an artifice or device was employed within the meaning of Treas. Reg. § 1.103-13(j).
2. Whether the Refunding Bonds were issued in connection with a device employed to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates as described in section 149(d)(4) of the Code.

CONCLUSIONS

1. Based on the facts provided, the Refunding Bonds appear to be arbitrage bonds under section 148(a) of the Code because an artifice or device was employed within the meaning of Treas. Reg. § 1.103-13(j).
2. There is a strong argument that the Refunding Bonds were issued in connection with a device employed to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates. Under that argument, the Refunding Bonds would be taxable under section 149(d)(4) of the Code.

FACTS

In Year 1, the Issuer issued its Series 1 Bonds and its Series 2 Bonds in the amounts of \$a and \$b, respectively. Debt service on the Series 1 and Series 2 Bonds was payable from revenues of the Issuer's System.

In Year 2, the Issuer issued the Refunding Bonds to advance refund the earliest maturities of the Series 1 and Series 2 Bonds (collectively, the "Refunded Bonds"). The yield on the Refunding Bonds is c percent. The Refunded Bonds were not callable and were to be redeemed at their scheduled maturity.

Debt service on the Refunding Bonds is payable from revenues derived from the operation of the Issuer's System. The Refunding Bonds were structured so that no debt service was due from the issue date of the Refunding Bonds through Date 1 (the "window period"). Revenues of the Issuer that were made available during the window period were deposited into a Special Reserve Fund, created pursuant to a resolution of the Issuer. According to such resolution, as well as the official statement for the Refunding Bonds, permissible uses for amounts in the Special Reserve Fund included the redemption of later maturities of the Series 1 and Series

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2 Bonds and expenditure on future capital projects. Funds in the Special Reserve Fund were invested in a Securities Purchase Contract (the "GIC"). The yield on the GIC was d percent, which was materially higher than the yield on the Refunding Bonds. The Verification Report prepared in connection with the issuance of the Refunding Bonds indicates that certain later maturities of the Series 1 and Series 2 Bonds were to be paid from the receipts from the GIC.

In Year 3, additional bonds were issued to advance refund the portion of the Series 1 and Series 2 Bonds not previously refunded, including those bonds that the Verification Report indicated were to be paid from the receipts from the GIC. Consequently, on Date 2, the GIC was terminated and a fee of \$e was paid to the Issuer in connection therewith.

LAW AND ANALYSIS

Whether the Refunding Bonds are Arbitrage Bonds

Section 103 provides for the exclusion from gross income of interest on any State or local bond. Section 103(b) provides that such exclusion shall not apply to an arbitrage bond within the meaning of section 148.

Section 148(a) provides that an arbitrage bond means any bond issued as part of an issue any portion of the proceeds of which is reasonably expected (at the time of issuance of the bond) to be used directly or indirectly to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part to acquire higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments.

Section 148 was added to the Code by section 1301 of the Tax Reform Act of 1986 (the "1986 Act"). The restrictions on arbitrage formerly were contained in section 103(c) of the Internal Revenue Code of 1954 (the "1954 Code"). Regulations under section 103(c) of the 1954 Code were contained in sections 1.103-13, 1.103-14, and 1.103-15, published as T.D. 7627, 1979-2 C.B. 45 (the "1979 Regulations").¹ The Conference Report to the 1986 Act states that "the conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions" for tax-exempt bonds. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686.

¹ Unless otherwise noted, all references to the Income Tax Regulations are to the 1979 Regulations.

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As the Refunding Bonds were issued prior to the promulgation of the regulations published as T.D. 8476, 1993-2 C.B. 13 (the "1993 Regulations"), and the Issuer has not elected into such regulations, section 1.103-13 applies for determining compliance with section 148.

Treas. Reg. § 1.103-13(j) provides that if an artifice or device is employed in connection with the issuance of a governmental obligation, such obligation will be considered an arbitrage bond. For purposes of this section, the term "artifice or device" means a transaction, or series of transactions, that attempts to circumvent the yield restriction provisions enabling –

- (i) the issuer to exploit the difference between tax-exempt and taxable interest rates to gain a material financial advantage, and
- (ii) increasing the burden on the market for tax-exempt obligations.

Section 1.103-13(j) further provides that examples of increased burdens on the market for tax-exempt obligations include selling obligations that would not otherwise be sold, selling more obligations than would otherwise be necessary, and issuing obligations sooner or allowing them to remain outstanding longer than would otherwise be necessary.

In determining compliance with the arbitrage provisions, the initial task is identifying the amounts that are subject to such provisions. In undertaking this analysis, the Code and the regulations both expressly extend the scope of the arbitrage provisions to the indirect investment of proceeds, as well as the use of proceeds to replace funds which are used to acquire higher yielding investments.

Rev. Rul. 78-348, 1978-2 C.B. 95, discusses the application of the replacement theory of section 103(c)(2)(B) of the 1954 Code, the predecessor to section 148(a)(2). The revenue ruling indicates that the replacement theory is based on the principle that an issuer that borrows to invest in higher yielding securities and one that borrows against such securities already owned are in virtually the same position. The revenue ruling provides that a requisite nexus must exist between the bonds and the securities in order for the securities to be considered replacement proceeds. The pledge need not be cast in any particular form. However, there must be reasonable assurance that the collateral will be available if needed to pay debt service. The ruling concludes that the required nexus exists where higher yielding securities are pledged as collateral for the bonds.

Replacement proceeds also arise when tax-exempt bonds are issued for a specific and limited purpose, and other amounts are set-aside for the same

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purpose. For example, Rev. Rul. 80-328, 1980-2 C.B. 53, describes a situation where an issuer contemporaneously issues long-term bonds at a yield of 9 percent and short-term notes at a yield of 7 percent to finance the same projects. The proceeds of the notes were to be used to pay the construction costs of the projects while the bond proceeds would be invested at a yield of 9 percent and held as security for the bondholders until completion of the projects. The ruling holds that the notes replace the bonds for arbitrage purposes while the bond proceeds are invested. Thus, the bond proceeds are replaced proceeds and are subject to the same yield restriction as the note proceeds. The transaction described in the ruling permitted the issuer to exploit the difference between tax-exempt and taxable rates to gain a material financial advantage. The effect of the contemporaneous issuance of notes and bonds was economically the same as if the bond proceeds were used to provide the project and the note proceeds were invested at 9 percent. In addition, issuing both notes and bonds in an aggregate principal amount of approximately twice the actual cost of the projects had the effect of increasing the burden on the market for tax-exempt obligations. Consequently, the notes were issued in connection with an artifice or device within the meaning of section 1.103-13(j).

In applying section 1.103-13(j), the Service has consistently looked beyond the direct investment of proceeds to determine whether the substance of a transaction results in an artifice or device. For example, in Rev. Rul. 82-101, 1982-1 C.B. 21, a state established a perpetual fund with proceeds from the sale of state-owned properties and invested the fund in taxable obligations with a yield materially higher than the yield on general obligation bonds that the state issued shortly afterwards as part of a series of related transactions. The income earned on the fund was either reasonably expected or reasonably assured of being available to pay the debt service on the bonds. The effect of the bond issuance was to borrow against securities in the fund. As a result, the proceeds of the bonds replaced the fund, and because the fund was invested at a materially higher yield, the revenue ruling holds that the issuer exploited the difference between tax-exempt and taxable rates to gain a material financial advantage. Further, because the debt service on the bonds was expected to be paid from the income earned on the fund, the ruling concludes that the full amount of bonds would not have been sold if the income from the fund were not available and, thus, the bonds increased the burden on the market for tax-exempt obligations within the meaning of section 1.103-13(j).

Based on the facts and circumstances of the instant case, there is a strong argument that the Refunding Bonds are an artifice or device within the meaning of section 1.103-13(j).

First, it appears that the structure of the Refunding Bonds enabled the Issuer to exploit the difference between tax-exempt and taxable interest rates to gain a

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material financial advantage. Absent the refunding, the revenues of the Issuer would have been used to pay debt service on the Refunded Bonds. In most refundings, the revenues released by the defeasance of prior bonds would be used to pay debt service on refunding bonds. The current transaction was structured, however, so that no debt service was due during the window period. There is also no indication that there was a non-arbitrage motivated reason for the creation of the window period, such as debt-service savings or making cash available for current needs due to financial distress. This permitted the Issuer to make revenues available that would have otherwise been used to pay debt service on the Refunding Bonds. These revenues were then invested in the GIC at a materially higher yield than the yield on the Refunding Bonds. Although proceeds of the Refunding Bonds were not directly invested in the GIC, the proceeds replaced the revenues that were then invested in the GIC. As a result, the revenues are replacement proceeds of the Refunding Bonds that were invested at a materially higher yield. Thus, on the facts provided, the difference between the yield on the Refunding Bonds and the yield on the GIC would be a material financial advantage which the Issuer was able to gain as a result of the issuance of the Refunding Bonds.

Second, there is a persuasive argument that the issuance of the Refunding Bonds increased the burden on the market for tax-exempt obligations. The Refunding Bonds were issued to advance refund the Refunded Bonds. However, the Refunded Bonds were not callable and were to be redeemed at maturity. Consequently, debt service savings on the Refunded Bonds was not possible. There is also no indication that there was any non-arbitrage motivated reason for issuing the Refunding Bonds. Therefore, it appears the issuance of the Refunding Bonds resulted in the issuance of more obligations than necessary and increased the burden on the market for tax-exempt obligations within the meaning of section 1.103-13(j).

Providing both elements of section 1.103-13(j) are met in this case as indicated above, the Refunding Bonds would be arbitrage bonds under section 148.

Section 149(d)(4)

Section 149(d)(1) provides in part that nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue issued to advance refund another bond if a device is employed in connection with the issuance of such issue to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates. Thus, the use of such a device in connection with the issuance of advance refunding bonds results in interest on the advance refunding bonds being taxable from the date of their issue.

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The General Explanation of the Senate Finance Committee Report on the Tax Reform Act of 1986 (the "Senate Report"), S. Rep. No. 99-313, 99th Cong., 2d Sess. (1986), 1986-3 (Vol. 3) C.B. 849-850, provides that the prohibition contained in section 149(d)(4) is intended to be similar to the "artifice or device" provisions of section 1.103-13(j), and is in fact intended to be broader, because section 149(d)(4) does not require a finding that there is an overburdening of the market for tax-exempt obligations.

Example 1 in the Senate Report, at 850 ("Example 1"), provides a useful illustration as to the types of transaction prohibited by section 149(d)(4). That example provides:

Pursuant to a transaction or series of transactions in connection with the issuance of advance refunding bonds, proceeds of the refunding bonds are allocated to amounts used to pay debt service on the refunded bonds which, absent the refunding, would have been paid with proceeds (other than proceeds in a reasonably required reserve fund) of the prior issue. Assume, for example, that proceeds of the refunding bonds are allocated to amounts used to pay the next installment of debt service on the refunded bonds. Absent the refunding, the next installment of debt service would have been paid with revenues accumulated on or before the date of issue of the refunding bonds (or capitalized interest on the refunded bonds).

Example 1 concludes that the transaction employed by the issuer is a device that permits the issuer to allocate the revenues to amounts used to pay a later installment of debt service on the refunded bonds and to invest the revenues and the earnings thereon substantially longer than they would have been invested absent the refunding.

Announcement 90-51, released prior to the issue date of the Refunding Bonds, indicated that the Service would be reviewing certain transactions involving the advance refunding of tax-exempt bonds. These transactions involve the issuance of refunding bonds to pay debt service on the earlier maturities of prior issues of tax-exempt bonds. Absent the refunding, revenues of the issuer would have been used to pay current debt service on the prior bonds. The refunding, however, allows these revenues to be used to pay debt service on the later maturities of the prior bonds. In the interim, these revenues are invested at a yield that is materially higher than the yield on the refunding bonds.

The Service noted in the announcement that Congress recognized some advance refundings serve legitimate purposes, including reduction of debt service costs and restructuring of debt to avoid burdensome covenants. Congress also acknowledged there are abusive advance refundings that employ devices to obtain

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a material financial advantage based on earning arbitrage. Accordingly, the Service announced it would review advance refunding transactions to determine whether they are of the type in which a device is employed to gain a material financial advantage prohibited by section 149(d)(4). To the extent that the Service decided to prohibit these types of transactions administratively, it was anticipated that such administrative action would be effective for bonds issued after March 30, 1990.

As discussed in the context of section 1.103-13(j), there is a strong argument that the issuance of the Refunding Bonds allowed the Issuer to gain a material financial advantage, apart from savings attributable to lower interest rates, by exploiting the difference between tax-exempt and taxable interest rates. Under the plain language of the statute, and as supported by the legislative history, the finding would be sufficient to establish that the Refunding Bonds employed a device within the meaning of section 149(d)(4) without a showing that they also overburdened the market.

Moreover, the substance of the transaction at issue is the same as the transactions described in Example 1 and Announcement 90-51. By issuing the Refunding Bonds and creating a window period where no debt service was payable, the Issuer was able to make revenues available that would have otherwise been used to pay debt service on the Refunding Bonds. There is no indication that there was a non-arbitrage motivated reason for the creation of the window period (e.g., debt-service savings or releasing cash for current needs due to financial distress). The available revenues were then invested at a yield materially higher than that on the Refunding Bonds. This material financial advantage was not attributable to lower interest rates because the Refunded Bonds were not callable prior to maturity, thus, debt service savings was not possible. Consequently, the advance refunding transaction in this case appears to be a device that enabled the Issuer to obtain a material financial advantage, based on arbitrage, apart from savings attributable to lower interest rates within the meaning of section 149(d)(4).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

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[REDACTED]

[REDACTED]

As discussed, there is a persuasive argument that the simultaneous creation of the Special Reserve Fund and the window period caused the Issuer's revenues to be replacement proceeds of the Refunding Bonds. Arguably, however, the revenues were also replacement proceeds (as a sinking fund) of the Refunded Bonds, as the Verification Report suggests such amounts were expected to be used to pay debt service on the Refunded Bonds. There are no clear rules on how to allocate amounts that may be replacement proceeds of two issues simultaneously. The tax-exempt bond rules could be potentially construed as requiring an allocation of the proceeds between the issues, which would lessen the amount of arbitrage earnings in this case. However, because the theory is that this transaction is abusive, the Service could argue that no such allocation is necessary, that amounts can be replacement proceeds of two issues simultaneously when the amounts arise in the connection with an abusive arbitrage device. This position is supported by Rev. Rul. 80-328 and section 1.148-6(b) of the current regulations.²

In arguing the validity of the current transaction, the Issuer cites proposed legislation, introduced April 18, 1990, two days after Announcement 90-51 was

² The result of Rev. Rul. 80-328 is that, in the context of an abusive arbitrage device, certain amounts were treated simultaneously as replacement proceeds of the notes and proceeds of the bonds. While Treas. Reg. § 1.148-6(b)(1) of the 1993 Regulations generally provides that amounts are allocable to only one issue at a time as gross proceeds, this "one-issue" rule does not apply where an issuer employs an abusive arbitrage device. Thus, the current regulations preserve the rule stated in Rev. Rul. 80-328.

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released. The contention is that the issuance of the Refunding Bonds complies with the proposed legislation and, thus, should not be treated as violating section 149(d)(4). [REDACTED]

The Issuer also contends that it expected to achieve debt service savings from the issuance of the Refunding Bonds without taking into account the investments in the Special Reserve Fund. As discussed above, the Refunded Bonds were not callable prior to maturity. Therefore, debt service savings attributable to lower interest rates on the Refunding Bonds does not appear possible. [REDACTED]

In addition to the issues discussed in response to your request for advice, there are additional issues that may warrant further development. [REDACTED]

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Please call if you have any further questions.

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cc: Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)