

Internal Revenue Service

Department of the Treasury

Number: **200403095**
Release Date: 1/16/2004
Index Number: 148.02-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:TEB-PLR-160177-02

Date:

September 30, 2003

Legend

- Corporation =
- Organization 1 =
- Organization 2 =
- State A =
- State B =
- Subsidiary 1 =
- Subsidiary 2 =
- Organization 1 Bonds =

- Organization 2 Bonds =

Date 1 =

Date 2 =

Date 3 =

Dear :

This is in response to your request for a ruling that Corporation may calculate a single yield on the Organization 1 Bonds and that it may calculate a single yield on the Organization 2 Bonds on behalf of Subsidiary 1 and Subsidiary 2, respectively, for purposes of section 148 of the Internal Revenue Code.¹

FACTS AND REPRESENTATIONS:

Organization 1 was established in State A as a not-for-profit corporation under section 501(c)(3) and operated as a qualified scholarship funding corporation (within the meaning of section 150(d)) for the purpose of acquiring student loan notes made pursuant to the Higher Education Act of 1965.

On Date 1, Organization 1 made an election under section 150(d)(3) to cease its status as a qualified scholarship funding corporation. In connection with that election, Organization 1 transferred substantially all of its assets and liabilities to a wholly-owned for-profit entity, Subsidiary 1. The liabilities transferred to Subsidiary 1 include the Organization 1 Bonds, tax-exempt bonds issued by Organization 1 to finance qualified student loans in State A. The Organization 1 Bonds consist entirely of bonds subject to the Tax Reform Act of 1986.

Organization 2 was established in State B as a not-for-profit corporation under section 501(c)(3) and operated as a qualified scholarship funding corporation (within the meaning of section 150(d)) for the purpose of acquiring student loan notes made pursuant to the Higher Education Act of 1965.

On Date 2, Organization 2 made an election under section 150(d)(3) to cease its status as a qualified scholarship funding corporation. In connection with that election, Organization 2 transferred substantially all of its assets and liabilities to a wholly-owned for-profit entity, Subsidiary 2. The liabilities transferred to Subsidiary 2 include the Organization 2 Bonds, tax-exempt bonds issued by Organization 2 to finance qualified student loans in State B. The Organization 2 Bonds consist entirely of bonds subject to the Tax Reform Act of 1986.

¹ Unless otherwise stated, all section references are to the Internal Revenue Code of 1986.

Corporation is a for-profit holding company organized for the purpose of establishing and owning the stock of corporations that engage in the securitization of financial assets. Corporation also provides managerial and administrative support to the corporations it owns.

Through a series of separate transactions culminating on Date 3, Corporation acquired 100 percent of the stock of both Subsidiary 1 and Subsidiary 2. Corporation manages the assets and liabilities of both Subsidiary 1 and Subsidiary 2, including the Organization 1 Bonds and the Organization 2 Bonds (collectively, the "Outstanding Issues"). Corporation also monitors Subsidiary 1's and Subsidiary 2's compliance with section 148 with respect to the Outstanding Issues.

The proceeds of the Outstanding Issues were originally used to make or acquire guaranteed student loans. The student loans financed by the Outstanding Issues bear interest at both variable and fixed-rates. The interest rate on guaranteed student loans is set by the U.S. Department of Education (the "Department") on July 1 of each year. The Corporation also receives varying levels of federal subsidies from the Department on the student loans in its portfolio. The amount of the subsidy received on each student loan is primarily based on two factors: (1) current interest rates; and (2) the statutory limitation on subsidies (the "subsidy limit") applicable to the particular type of student loan. The subsidy limit that applies to each student loan in Corporation's portfolio depends, in part, on the date of issue of the bond issue that financed the student loan.

As student loans financed with the Outstanding Issues are repaid, the proceeds may be recycled into new student loans. However, the ability to finance new student loans with the proceeds of any issue that comprises the Outstanding Issues may be affected by several factors, including the current rate on student loans, the subsidy limit that would apply to the newly financed loan, and the subsidy limits that apply to the existing student loans in Corporation's portfolio. There are additional legal restrictions on the ability to finance new student loans from the proceeds of the Outstanding Issues. For example, proceeds of the Organization 1 Bonds may only be used to originate student loans in State A and proceeds of the Organization 2 Bonds may only be used to originate student loans in State B.

The student loans in Corporation's portfolio were financed from various issues and not all Outstanding Issues are subject to the same definition of materially higher for purposes of section 148. For example, the Organization 2 Bonds include bond issues for which the permitted yield spread on program investments is 2 percent and bond issues for which the permitted yield spread on program investments is 1.5 percent.

Currently, the yield on each of the issues that comprise the Outstanding Issues as well as the yield on the investment of gross proceeds of each such issue (including the student loans) is calculated separately for purposes of section 148. The separate yield calculations limit Corporation's ability to manage the student loans financed with the Organization 1 Bonds and the Organization 2 Bonds as single portfolios operated in

State A and State B, respectively. For example, while the aggregate earnings on student loans financed by the Organization 1 Bonds may be sufficient to support the total debt service on those bonds, the aggregate earnings may not be sufficient after the materially higher limits under section 148 are applied to each separate bond issue (and the loans allocable to each issue).

The calculation of separate yields may also result in the disparate treatment of the student borrowers. Corporation has a program for returning earnings on student loans in excess of the permitted yield to borrowers by forgiving a portion of the student loan, rather than remitting yield reduction payments to the United States. Because some of the Outstanding Issues have yields above the loan rates set by the Department while other issues have yields below loan rates, only certain borrowers may receive monetary benefits through loan forgiveness based on the particular bond issue that financed the loan.

Corporation requests that it be permitted to calculate single yields on behalf of Subsidiary 1 for all of the Organization 1 Bonds and on behalf of Subsidiary 2 for all of the Organization 2 Bonds pursuant to section 1.148-4(a). Corporation represents the following business reasons for calculating single yields. First, It will allow Corporation to more effectively manage the student loans financed by the Organization 1 Bonds and the Organization 2 Bonds, respectively, as single portfolios. This, for example, will allow Corporation to more efficiently recycle loans financed by the Outstanding Issues notwithstanding interest rate fluctuations, the varying interest rates on the bonds and the student loans, and the varying subsidy limits on the student loans. Second, it will allow Corporation to forgive student loans in a nondiscriminatory manner, that is, without regard to the specific bond issue that financed the student loan. Finally, it will enable Corporation to more efficiently monitor its compliance with the arbitrage rules.

Each of the issues that comprise the Outstanding Issues that is not subject to the final regulations under section 148, contained in 26 CFR Part 1 as revised August 4, 2003 (the "Final Regulations"), will apply such regulations as permitted by section 1.148-11(b)(1). The single yield computations for both the Organization 1 Bonds and the Organization 2 Bonds will be calculated by treating each of the issues that comprise the Organization 1 Bonds and each of the issues that comprise the Organization 2 Bonds as a single issue, respectively. Because both the Organization 1 Bonds and the Organization 2 Bonds each contain variable rate bonds, the single yields for both the Organization 1 Bonds and the Organization 2 Bonds will be calculated as variable yield issues beginning with the dates of issuance of the first issue of the Organization 1 Bonds and the first issue of the Organization 2 Bonds, respectively. Computation date options in section 1.148-3(e)(1) for variable yield issues will be selected upon the approval of the ruling request and consistently applied thereafter.

Because each of the issues that comprise the Outstanding Issues are applying the Final Regulations, the yield on all the student loans financed by the Outstanding Issues will be recomputed as program investments applying the 2 percentage point limitation of section 1.148-2(d)(2)(iv). Thus, special allowance payments made by the

Secretary of Education will be also included as receipts for purposes of computing the yield on the student loans as required by section 1.148-5(b)(5). As program investments, the only qualified administrative costs permitted will be the costs of issuing, carrying, or repaying the issue, and any underwriter's discount as provided by section 1.148-5(e)(3)(ii)(B).

Prior rebate payments made with respect to the Organization 1 Bonds or the Organization 2 Bonds will be treated as payments of the combined liability of the Organization 1 Bonds or the Organization 2 Bonds, respectively.

LAW:

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that subsection (a) shall not apply to any arbitrage bond (within the meaning of section 148).

Section 148(a) provides that the term "arbitrage bond" means 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 bond) to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. For purposes of section 148(a), 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 in a manner described in (1) or (2) of the prior sentence.

Section 148(b)(1) provides that the term "higher yielding investments" means any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue. Section 1.148-2(d)(1) provides that the yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of materially higher prescribed in the regulations under section 148. Section 1.148-2(d)(2)(i) defines materially higher yield generally for purpose and nonpurpose investments as one-eighth of 1 percentage point. Section 1.148-2(d)(2)(iv) provides that for qualified student loans that are program investments, materially higher means 2 percentage points.

Section 1.148-1(b) states that a purpose investment is an investment that is acquired to carry out the governmental purpose of the issue. Section 1.148-1(b) defines a program investment, generally, as a purpose investment that is part of a governmental program that meets certain requirements enumerated in the regulations.

Section 1.148-4 provides rules for computing the yield on an issue of bonds to apply investment yield restrictions and to compute rebate liability. Section 1.148-4(c)(1) provides, generally, that yield on a variable yield issue is computed separately for each

computation period. The yield for each computation period is the discount rate that, when used in computing the present value as of the first day of the computation period of all the payments of principal and interest and fees for qualified guarantees that are attributable to the computation period, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price (or deemed issue price) of the bonds of the issue as of the first day of the computation period.

Under section 1.148-3(e)(1), an issuer of a variable yield issue may treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid (under § 1.148-3(f)) as a computation date but may not change that treatment after the first payment date and, after the first required payment date, must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date.

Section 1.148-4(a) provides that the Commissioner may permit issuers of qualified mortgage bonds or qualified student loan bonds to use a single yield for two or more issues. Section 1.148-1(b) provides that 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.

Section 1.148-5 provides, in general, rules for computing the yield and value of investments allocated to an issue for various purposes under section 148. Section 1.148-5(b)(1) provides, in part, that,

the yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. For this purpose, payments means amounts to be actually or constructively paid to acquire the investment, and receipts means amounts to be actually or constructively received from the investment, such as earnings and return of principal. The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue.

Section 1.148-5(b)(5) provides that, except as provided in section 1.148-11(e), the yield on qualified student loans is computed by including as receipts any special allowance payments made by the Secretary of Education pursuant to section 438 of the Higher Education Act of 1965.

Section 1.148-11(a) generally provides that the provisions of sections 1.148-1 through 1.148-11 apply to bonds sold on or after July 8, 1997. Section 1.148-11(b)(1) further provides that an issuer may apply the provisions of §§ 1.148-1 through 1.148-11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject

to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954.

Section 150(d)(1) provides, in part, that for purposes of section 103, a qualified scholarship funding bond shall be treated as a State or local bond. Section 150(d)(2) further provides that the term qualified scholarship funding bond means a bond issued by a corporation which:

(A) is a corporation not for profit established and operated exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965, and

(B) is organized at the request of the State or one or more political subdivisions thereof or is requested to exercise such power by one or more political subdivisions and required by its corporate charter and bylaws, or required by State law, to devote any income (after payment of expenses, debt service, and the creation of reserves for the same) to the purchase of additional student loan notes or to pay over any income to the United States.

Section 150(d)(3) provides that an outstanding qualified scholarship funding bond, and qualified student loan bond, shall not fail to be a tax-exempt bond solely because the issuer ceases to be described as a qualified scholarship funding corporation if the issuer meets the requirements of subparagraphs (B) and (C) of that section. The requirements of section 150(d)(3)(B) are met by an issuer if--

(i) all of the student loan notes of the issuer and other assets pledged to secure the repayment of qualified scholarship funding bond indebtedness of the issuer are transferred to another corporation within a reasonable period after the election is made;

(ii) such transferee corporation assumes or otherwise provides for the payment of all of the qualified scholarship funding bond indebtedness of the issuer within a reasonable period after the election is made;

(iii) to the extent permitted by law, such transferee corporation assumes all of the responsibilities, and succeeds to all of the rights, of the issuer under the issuer's agreements with the Secretary of Education in respect of student loans;

(iv) immediately after such transfer, the issuer, together with any other issuer which has made an election in respect of such transferee, hold all of the senior stock in such transferee corporation; and

(v) such transferee corporation is not exempt from tax under this chapter.

The requirements of section 150(d)(3)(C) are met by an issuer if, within a reasonable period after the transfer referred to in section 150(d)(3)(B)--

- (i) the issuer is described in section 501(c)(3) and exempt from tax under section 501(a);
- (ii) the issuer no longer is described in section 150(d)(2)(A) or (B); and
- (iii) at least 80 percent of the members of the board of directors of the issuer are independent members.

ANALYSIS:

Currently, the yield on each of the Outstanding Issues (and the investment of gross proceeds for each of the respective issues) is computed separately for purposes of compliance with section 148. The Corporation requests, under section 1.148-4(a), that it be permitted to compute single yields for the Organization 1 Bonds and the Organization 2 Bonds, respectively. The current request requires us to consider two issues: 1) whether the use of a single yield for two or more issues of outstanding student loan bonds is permitted after an election is made under section 150(d)(3) to cease status as a qualified scholarship funding corporation; and 2) whether a single yield computation for two or more issues is permitted under the facts and circumstances of this case.

Section 150(d)(3) provides that an outstanding qualified scholarship funding bond, and qualified student loan bond, shall not fail to be a tax-exempt bond solely because the issuer ceases to be described as a qualified scholarship funding corporation, provided certain conditions are met. Consequently, bonds that remain outstanding after the section 150(d)(3) election must still comply with all requirements for tax-exempt bonds under sections 103 and 141 through 150.

Corporation represents that the parties took all actions required under section 150(d)(3) when Organization 1 and Organization 2 transferred their assets and liabilities, including the Organization 1 Bonds and the Organization 2 Bonds, to Subsidiary 1 and Subsidiary 2, respectively. As the successors to the issuers of the Organization 1 Bonds and the Organization 2 Bonds, Subsidiary 1 and Subsidiary 2 are under a continuing obligation to ensure the issues continue to comply with the requirements for tax-exempt bonds in general, and the arbitrage requirements of section 148, in particular. Just as section 150(d)(3) does not lessen the compliance requirements with respect to the Outstanding Issues, it generally does not affect the rights with respect to such bonds. Thus, Corporation, as the 100 percent shareholder of both Subsidiary 1 and Subsidiary 2, may request permission to calculate single yields on the Organization 1 Bonds and the Organization 2 Bonds, respectively.

The authority to permit issuers of qualified student loan bonds to use a single yield for two or more issues is contained in section 1.148-4(a) of the Final Regulations.

In this case, the Corporation has proposed to apply the Final Regulation to all Outstanding Issues (*e.g.*, recomputing the yield on the student loans financed by both the Organization 1 Bonds and the Organization 2 Bonds as program investments and applying the 2 percentage point limitation of section 1.148-2(d)(2)(iv)).

Corporation has also presented valid business reasons for permitting single yields on more than one issue. As described above, treating each of the issues that comprise the Outstanding Issues as a separate issue for purposes of section 148 limits the ability of the Corporation to manage the student loans financed in State A as a single portfolio and the student loans financed in State B as a single portfolio. By contrast, permitting single yield computations will allow Corporation to more effectively manage the student loans financed by the Organization 1 Bonds as a single portfolio and the student loans financed by the Organization 2 Bonds as a single portfolio. Moreover, single yields will also enable the Corporation to forgive student loans in a nondiscriminatory manner within each state. Finally, single yields will also permit more efficient monitoring and compliance with the arbitrage rules.

Based on the facts and circumstances, Corporation may calculate single yields on the Organization 1 Bonds and the Organization 2 Bonds, respectively, for purposes of section 148.

CONCLUSIONS:

Corporation may calculate a single yield on the Organization 1 Bonds on behalf of Subsidiary 1 and a single yield on the Organization 2 Bonds on behalf of Subsidiary 2 for purposes of section 148.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether

interest on the Outstanding Issues is excludable from gross income under section 103(a) or whether the requirements of section 150(d)(3) were met.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

By:

Bruce M. Serchuk
Senior Technician Reviewer
Tax Exempt Bond Branch