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Date:  
May 21, 2014

LEGEND

Bonds =

Issuer =

Borrower =

Bondholder =

Swap Counter-Party =

Series B Bonds =

Date 1 =

Date 2 =

Date 3 =

Maturity 1 =

Maturity 2 =

Dear :

This letter is in response to your request for a ruling that (1) the extension of the Total Return Swap (TRS) described herein will be not be an abusive arbitrage device within the meaning of § 1.148-10(a) and (2) the TRS described herein will not be integrated with the Bonds under the authority of the Commissioner in § 1.148-10(e).

#### FACTS AND REPRESENTATIONS

The Bonds were issued on Date 1 as fixed rate, term bonds maturing in Maturity 1 and fixed rate, term bonds maturing in Maturity 2. The Bonds are subject to scheduled mandatory redemption as provided in the indenture of trust for the Bonds and optional redemption on or after Date 3. The Bonds were priced to the first optional call on or after Date 3. The proceeds of the Bonds were used, pursuant to a financing lease between the Issuer (conduit issuer) and the Borrower (conduit borrower), to refund, as a current refunding, certain of the Issuer's prior bonds that had been issued for the benefit of the Borrower. All proceeds of the Bonds were allocated to the current refunding and payment of issuance costs within 30 days. There are no gross proceeds of the Bonds available for investment since the Bonds do not have a reserve fund and the debt service fund receives revenues only as debt service becomes due. There were no transferred proceeds.

The Bonds were purchased on Date 1 by the Bondholder in an arms'-length private placement transaction to hold in its own account with no intention to reoffer the Bonds, although there are no restriction on its doing so.

On Date 1, the Borrower and the Bondholder (also referred to herein as the Swap Counter-Party depending on the context) entered into a total return swap (TRS) with respect to each maturity of the Bonds (the terms of each TRS are essentially identical and the term TRS herein refers to both agreements.) The notional principal amount of the TRS equals the principal amount of the Bonds and amortizes as the Bonds amortize. Under the TRS, the Swap Counter-Party makes fixed rate payments to the Borrower and the Borrower makes variable rate payments to the Swap Counter-Party based on the SIFMA Index. By comparing the coupon rate on the Bonds with the Swap Counter-Party's fixed payment under the TRS, the Borrower's net cost of financing is SIFMA plus 95 basis points. The TRS terminates on Date 2.

The TRS provides price protection with respect to the Bonds to both the Counter-Party and the Borrower. Upon termination of the TRS, a termination payment is due between the parties in an amount equal to the difference between the fair market value of the Bonds on the termination date and the base price of the Bonds as stated in the TRS. If the value of the Bonds is below the base price, the TRS requires the Borrower to pay the difference to the Counter-Party. If the value of the bonds is above the base price, the Counter-Party must pay the difference to the Borrower.

The Borrower has the right to terminate the TRS upon 3 business days' notice. The Counter-Party has the right to terminate the TRS only upon occurrence of one of the early termination events provided in the TRS. An early termination of the TRS does not impact the legal rights and obligations of the Borrower or the Bondholder with respect to the Bonds. The termination payment under the TRS cannot be offset by payments under the Bonds. The TRS does not require the Swap Counter-Party to own the Bonds at any point during its effectiveness and the Bonds are freely transferable by the Bondholder with no effect on the cash flows or termination value of the TRS.

The optional call rights on the Bonds are not addressed by the terms of the TRS or its proposed extension.

When the Bonds were issued, neither the Issuer nor the Borrower identified a swap on Form 8038, or otherwise, to integrate as a qualified hedge the TRS with the Bonds for purposes of § 1.148-4.

The Borrower and the Swap Counter-Party now plan to amend the TRS to extend its term for an additional 5 years (approximately 7 years from issuance of the Bonds). This amendment will occur several years before the first optional call date for the Bonds but will extend the term of the TRS beyond that call date. The pricing of the TRS will also be amended so that the Borrower's net financing cost will be reduced to the SIFMA index plus 80 basis points. This new pricing reflects improved market conditions and the improved credit quality of the Borrower. The modified pricing was negotiated in an arms' length transaction and reflects fair market value pricing. The Bondholder represents that the Issuer will treat, as a precautionary matter, this amendment and extension of the TRS as a potential reissuance of the Bonds and will file a new Form 8038 without indicating that the hedge has been identified for integration under section 1.148-4.

## LAW

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any State or local bond. Subsection (b) provides, in part, that subsection (a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 148(a) provides that, for purposes of § 103, the term “arbitrage bond” means bond issued as part of an issue any portion of the proceeds of which are reasonably expected (as 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 this subsection, 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 paragraph (1) or (2).

Section 1.148-1(b) provides that 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 1.148-4(h)(1) provides that payments made or received by an issuer under a qualified hedge (as defined in paragraph (h)(2) of this section) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue. Except as provided in paragraphs (h)(4) and (h)(5)(ii)(E) of this section, the bonds to which a qualified hedge relates are treated as variable yield bonds from the issue date of the bonds. This paragraph (h) applies solely for purposes of §§ 143(g), 148, and 149(d).

Section 1.148-4(h)(2)(viii) provides that the contract must be identified by the actual issuer on its books and records maintained for the hedged bonds not later than 3 days after the date on which the issuer and the hedge provider enter into the contract. The identification must contain sufficient detail to establish that the requirements of this paragraph (h)(2) and, if applicable, paragraph (h)(4) of this section are satisfied. In addition, the existence of the hedge must be noted on the first form relating to the issue of which the hedged bonds are a part that is filed with the Internal Revenue Service on or after the date on which the contract is identified pursuant to this paragraph (h)(2)(viii).

Section 1.148-10(a)(1) provides that bonds of an issue are arbitrage bonds under § 148 if an abusive arbitrage device under paragraph (a)(2) of this section is used in connection with the issue. This paragraph (a) is to be applied and interpreted broadly to carry out the purposes of § 148, as further described in § 1.148-0. Except as otherwise provided in paragraph (c) of this section, any action that is expressly permitted by § 148 or §§ 1.148-1 through 1.148-11 is not an abusive arbitrage device.

Section 1.148-10(a)(2) provides that any action is an abusive arbitrage device if the action has the effect of (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and (ii) overburdening the tax-exempt bond market.

Section 1.148-10(a)(3) provides that an action may exploit tax-exempt interest rates under paragraph (a)(2) of this section as a result of an investment of any portion of the

gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

Section 1.148-10(a)(4) provides, in part, that an action overburdens the tax-exempt bond market under paragraph (a)(2)(ii) of this section if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit).

Section 1.148-10(e) provides that if an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of §§ 1.148-1 through 1.148-11 as necessary to clearly reflect the economic substance of the transaction. For this purpose, the Commissioner may recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue.

## ANALYSIS

### THE TRS AS AN ABUSIVE ARBITRAGE DEVICE

The Bondholder has represented that the Bonds were issued as current refunding bonds and all sale and any investment proceeds were expended for the refunding purpose within 30 days of issuance. The Bonds do not have a reserve fund and the debt service fund is funded on or about the date that debt service on the Bonds is due. There are no replacement proceeds otherwise created and no transferred proceeds were received. The proposed extension of the TRS does not affect the gross proceeds of the Bonds and does not alter the aforementioned representations.

Section 1.148-10(a)(2) provides that any action is an abusive arbitrage device if the action has the effect of: (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage ("rate exploitation") and (ii) overburdening the tax-exempt bond market ("overburdening"). Both rate exploitation and overburdening must be present to result in an abusive arbitrage device.

We conclude that the original structure of the financing plan, including the TRS, and the extension of the TRS for the Bonds does not enable the Borrower to exploit a difference between tax-exempt and taxable interest rates to obtain a material financial advantage. The financing structure does not result in any gross proceeds available for non-purpose investment beyond the first 30 days during which initial time period they qualified for an applicable temporary period. The financing structure and the terms of the TRS extension do not reflect an intent to exploit tax-exempt versus taxable interest rate differentials for arbitrage purposes. Since rate exploitation is not present, it is unnecessary to determine if overburdening is present.

#### INTEGRATION OF THE TRS WITH THE BONDS

Section 1.148-10(e) provides a grant of discretionary authority to the Commissioner to implement the anti-abuse rules if an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148. This authority permits the Commissioner to depart from the rules of §§ 1.148-1 through 1.148-11 as necessary to clearly reflect the economic substance of a transaction.

Section 1.148-1(b) defines issuer to include the issuer and each conduit borrower of the issue, unless the context or a provision clearly requires otherwise.

We conclude that the structure of the original financing, including the TRS, and the proposed extension of the TRS does not reflect a principal purpose by the Borrower to obtain a material financial advantage by either rate exploitation or by overburdening. Improved market conditions and the improved credit quality of the Borrower are the motivating factors for the extension. The modified pricing reflected in the extension was negotiated in an arms' length transaction based on fair market value pricing and not on the amount of arbitrage earned or expected to be earned on the hedged bonds in a manner that is inconsistent with the purposes of § 148.

#### CONCLUSION

Based solely on the documents provided to us and the factual representations made by the Bondholder, we conclude that (i) the extension of the TRS will not be an abusive arbitrage device under § 1.148-10(a) and (ii) the TRS described herein will not be integrated with the Bonds under the authority of the Commissioner in § 1.148-10(e).

Except as expressly provided herein, no opinion is expressed or implied about the tax consequences of any transaction or item discussed in this letter. We specifically express no opinion about whether the extension of the TRS causes a reissuance under § 1001 or about Issuer's precautionary treatment of such extension as a reissuance.

We also specifically express no opinion about whether interest paid on the Bonds may be excluded from gross income under § 103(a).

This ruling is directed only to the taxpayer and bondholder who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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

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

Sincerely,

Associate Chief Counsel (Financial  
Institutions and Products)

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By: \_\_\_\_\_  
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