

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Chief Counsel Advice Memorandum

This memorandum responds to your request for advice regarding the use of tax-exempt bonds to advance refund taxable bonds.

ISSUE

Whether § 149(d) of the Internal Revenue Code (the “Code”),¹ as amended by § 13532 of Public Law No. 115-97, 131 Stat 2054, 2154 (2017) (the “2017 Act”), precludes the issuance of tax-exempt bonds to advance refund non-tax-advantaged, taxable bonds as described below?

CONCLUSION

Section 149(d), as amended by § 13532 of the 2017 Act, does not preclude the issuance of tax-exempt bonds to advance refund non-tax-advantaged, taxable bonds under the facts described below. There will not be two sets of tax-advantaged bonds outstanding for the same project or activity.

FACTS

In 2010, a local government (“Issuer”) issued build America bonds (the “BABs”) with serial

¹ Unless otherwise stated, all section references are to sections of the Internal Revenue Code or the Income Tax Regulations.

maturities in years 2011 through 2035. The Issuer elected to receive refundable credits under § 6431 (direct payments) with respect to the BABs. The BABs were callable at par in year 2020, and on each interest payment date thereafter. On July 1, 2018, the Issuer issued bonds (the “Refunding Bonds”) to redeem the BABs maturing in years 2021 through 2035 (the “Selected Bonds”) and deposited the proceeds of the Refunding Bonds in a defeasance escrow with an escrow agent. The Issuer provided irrevocable instructions to the escrow agent to call the Selected Bonds in 2020 and obtained a verification report from an accounting firm indicating that the cash and maturing investments in the defeasance escrow were sufficient to pay principal and interest on the Selected Bonds to and including the call date in the year 2020. After the deposit of the proceeds of the Refunding Bonds into the defeasance escrow, the holders of the Selected Bonds were entitled to look only to the defeasance escrow for payment and security. On July 1, 2018, bond counsel to the Issuer rendered a legal opinion that the Selected Bonds were legally defeased for purposes of state law, reissued for federal tax purposes, and no longer eligible for direct payments for interest accruing on or after July 1, 2018. Thus, the reissued Selected Bonds (the “Defeased Bonds”) were not tax-advantaged, taxable bonds. There is no indication that the Issuer intended the Defeased Bonds to qualify as tax-exempt bonds under § 103.

LAW AND ANALYSIS

Section 103(a) provides generally that gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that § 103(a) shall not apply to any bond unless such bond meets the applicable requirements of § 149.

Section 149(d)(1) provides that nothing in § 103(a) or in any other provision of the law shall be construed to provide an exemption from federal income tax for interest on any bond issued to advance refund another bond. Section 149(d)(2) provides that for purposes of §§ 141 through 150, a bond shall be treated as issued to advance refund another bond if it is issued more than 90 days before the redemption of the refunded bond.

Section 1.149(d)-1(e) of the Income Tax Regulations was published as part of T.D. 8476, 58 Fed. Reg. 33510, 33548 (June 18, 1993). Section 1.149(d)-1(e)(1) provides that except as provided in § 1.149(d)-1(e)(2), for purposes of § 149(d)(3)(A)(i), an advance refunding issue the interest on which is not excludable from gross income under § 103(a) (*i.e.*, a taxable advance refunding issue) is not taken into account. In addition, for this purpose, an advance refunding of a taxable issue is not taken into account unless the taxable issue is a conduit loan of a tax-exempt conduit financing issue.

Section 1.149(d)-1(e)(2) provides that a taxable issue is taken into account under § 149(d)(3)(A)(i) if it is issued to avoid the limitations of that section. For example, in the case of a refunding of a tax-exempt issue with a taxable advance refunding issue that is, in turn, currently refunded with a tax-exempt issue, the taxable advance refunding issue is taken into account under § 149(d)(3)(A)(i) if the two tax-exempt issues are outstanding

concurrently for more than 90 days.

Section 54AA(d)(1)² provides that for purposes of § 54AA, the term “build America bond” means any obligation (other than a private activity bond) if (A) the interest on such obligation would (but for § 54AA) be excludable from gross income under § 103, (B) such obligation is issued before January 1, 2011, and (C) the issuer makes an irrevocable election to have § 54AA apply. Section 54AA(f)(1) provides that interest on any build America bond shall be includible in gross income. The holder of a build America Bond may be allowed a tax credit under § 54AA(a) or, alternatively, the issuer may elect under § 54AA(g) to receive a refundable credit under § 6431.

Section 1.150-1(b) defines a tax-advantaged bond to mean a tax-exempt bond, a taxable bond that provides a federal tax credit to the investor with respect to the issuer’s borrowing costs, a taxable bond that provides a refundable federal tax credit payable directly to the issuer of the bonds for its borrowing costs under § 6431, or any future similar bond that provides a federal tax benefit that reduces the issuer’s borrowing costs.

The facts indicate that the Selected Bonds, which were build America bonds, were retired and refunded by the Defeased Bonds, which were non-tax-advantaged, taxable bonds. The Refunding Bonds, being issued more than 90 days before the call date of the Defeased Bonds, advance refunded the Defeased Bonds. The issue in this case, thus, is whether § 149(d) precludes the Refunding Bonds from being tax-exempt bonds because of the advance refunding of the Defeased Bonds, which are non-tax-advantaged, taxable bonds.

Under § 1.149(d)-1(e), an advance refunding of a taxable issue is not taken into account unless the taxable issue is a conduit loan of a tax-exempt conduit financing issue or is issued to avoid the limitations on tax-exempt advance refundings. This regulation, however, was published before the amendment of § 149(d) by the 2017 Act and before the enactment of § 54AA and other provisions creating taxable bonds that are tax-advantaged, such as build America bonds.³ For purposes of this regulation, a non-tax-advantaged issue is treated as a taxable issue in determining whether a bond is being issued to advance refund another bond.

In limiting advance refunding bonds, Congress consistently has focused on tax-advantaged bonds. The House Report to the 2017 Act states:

² Section 54AA of the Code was repealed by § 13404 of the 2017 Act, 131 Stat 2054, 2138 (2017), effective for bonds issued after December 31, 2017. All references to § 54AA refer to this section as in effect prior to its repeal.

³ The first tax-advantaged, taxable bonds were Qualified Zone Academy Bonds, created in August 1997, Pub. L. No. 105-34, § 226(a), 111 Stat 788, 821 (1997). These were followed by other such bonds, for example, Clean Renewable Energy Bonds in 2005, Pub. L. No. 109-58, § 1303(a), 119 Stat 594, 991 (2005), Qualified Energy Conservation Bonds in 2008, Pub. L. No. 110-343, § 301(a), 122 Stat 3765, 3841 (2008), and build America bonds in 2009, Pub. L. No. 111-5, § 1531(a), 123 Stat 115, 358 (2009). The ability to issue tax-advantaged, taxable bonds after December 31, 2017, was repealed by the 2017 Act, § 13404, 131 Stat 2054, 2138 (2017).

The ability to issue advance refunding bonds allows State and local governments to issue and have outstanding two sets of Federally subsidized debt associated with the same activity. The Committee believes that a single activity should have a maximum of only one set of Federally subsidized debt, and so believes removing the ability to issue tax-advantaged advance refunding bonds is appropriate. H.R. Rep. No. 115-409, at 308 (2017). See *also* S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 227 (2017).

Similarly, the House report to the Tax Reform Act of 1986, Pub. L. No. 99-514, 1986-3 (Vol. 1) C.B. 1 (the “1986 Act”), states:

The Committee also desires to place stringent controls on advance refunding of tax-exempt bonds. ... Advance refunding is inefficient in that it often results in many times the original volume of a single bond issue being outstanding. Given the committee’s desire to control the volume of tax-exempt obligations and to eliminate economic inefficiencies, the bill extends the present-law prohibition on advance refunding.” H.R. Rep. No. 99-426, at 518 (1985), 1986-3 (Vol. 2) C.B. 518.

The Senate Report to the 1986 Act states: “The Committee has also restricted the advance refunding of tax-exempt bonds. ... Advance refunding results in multiple issues of bonds outstanding simultaneously and thereby results in multiple indirect Federal subsidies attributable to tax-exempt financing for a single activity.” S. Rep. No. 99-313, at 828 (1986), 1986-3 (Vol. 3) C.B. 828.

Under the facts presented, the Defeased Bonds are non-tax-advantaged bonds. The Refunding Bonds were not outstanding concurrently with the BABs. Thus, there are not two sets of tax-advantaged bonds outstanding for the same project or activity, and the Defeased Bonds are disregarded. Accordingly, § 149(d), as amended by § 13532 of the 2017 Act, does not preclude the Refunding Bonds from being tax-exempt bonds under § 103.