

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

(TEGE Division Counsel)

from:

(Financial Institutions & Products)

subject: Chief Counsel Advice Memorandum

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

- (1) Does the conversion of an issuer's U.S. Treasury Securities – State and Local Government Series Demand Deposit securities (Demand Deposit SLGS) to special 90-day certificates of indebtedness (Special 90-day C of I) pursuant to 31 CFR § 344.7(b) cause the issuer to fail to meet the continuous investment requirement of the safe harbor for longer-term working capital financings under § 1.148-1(c)(4)(ii)(C) of the Income Tax Regulations under the facts described below?¹

- (2) Does an issuer's investment in Demand Deposit SLGS lose its status as a tax-exempt bond under § 1.150-1(b) when there is a conversion of the Demand Deposit SLGS to Special 90-day C of I pursuant to 31 CFR § 344.7(b), if the Special 90-day C of I are reinvested in Demand Deposit SLGS when the issuance of Demand Deposit SLGS resumes?

¹ Unless otherwise specified, all "section" or "§" references are to sections of the Internal Revenue Code or the Income Tax Regulations (26 CFR part 1).

CONCLUSIONS

- (1) Under the facts described below, the conversion does not cause the issuer to fail to meet the continuous investment requirement of the safe harbor for longer-term working capital financings.
- (2) The conversion does not cause the issuer's investment to lose its status as a tax-exempt bond.

FACTS

Situation 1

Issuer A invested its available amounts (as defined for purposes of § 1.148-1(c)(4)(ii)) in Demand Deposit SLGS, thereby meeting the requirements of the safe harbor against the creation of replacement proceeds for longer-term working capital financings provided in § 1.148-1(c)(4)(ii). On Date 1, Issuer A's Demand Deposit SLGS were converted, pursuant to 31 CFR § 344.7(b), into Special 90-day C of I. On Date 2, the issuance of Demand Deposit SLGS resumed, and the Special 90-day C of I were reinvested in Demand Deposit SLGS.

Situation 2

Issuer B invested replacement proceeds (as defined in § 1.148-1(c)) in Demand Deposit SLGS for the purpose of avoiding acquisition of higher yielding investments as defined in § 148(b). On Date 1, Issuer B's Demand Deposit SLGS were converted, pursuant to 31 CFR § 344.7(b), into Special 90-day C of I. On Date 2, the issuance of Demand Deposit SLGS resumed, and the Special 90-day C of I were reinvested in Demand Deposit SLGS.

LAW

Section 103(a) of the Internal Revenue Code provides that, except as provided in § 103(b), 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 arbitrage bond (within the meaning of § 148).

Section 148(a) defines an arbitrage bond as 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. Section 148(a) further provides that a bond is 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).

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 148(b)(3)(A) provides that, except as provided in § 148(b)(3)(B), the term “investment property” does not include any tax-exempt bond. Section 148(b)(3)(B) provides that with respect to an issue other than an issue a part of which is a specified private activity bond (as defined in § 57(a)(5)(C)), the term “investment property” includes a specified private activity bond (as so defined).

Section 1.150-1(b) provides that, for purposes of § 148, tax-exempt bond includes a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Section 1.148-2(a) provides, in part that under § 148(a), the direct or indirect investment of gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds.

Section 1.148-1(b) defines “gross proceeds” to mean any proceeds and replacement proceeds of an issue. Section 1.148-1(c) provides the definition of replacement proceeds. Section 1.148-1(c)(1) provides, in part, that replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in § 1.148-1(c)(4), to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue.

Section 1.148-1(c)(4)(i)(A) provides that replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that: (1) the term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue; and (2) there will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148-10. Replacement proceeds are created under § 1.148-1(c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

Section 1.148-1(c)(4)(i)(B)(4) provides, as a safe harbor, that replacement proceeds do not arise under § 1.148-1(c)(4)(i)(A) for the portion of an issue (including a refunding issue) that is to be used to finance working capital expenditures, if that portion satisfies § 1.148-1(c)(4)(ii). Section 1.148-1(c)(4)(ii) provides a safe harbor for longer-term working capital financings. Section 1.148-1(c)(4)(ii)(A) and (B) generally require annual testing for available amounts and application of the available amounts to redeem or to invest in eligible tax-exempt bonds (as defined in § 1.148-1(c)(4)(ii)(E)).

Section 1.148-1(c)(4)(ii)(C) provides that, except as provided in § 1.148-1(c)(4)(ii)(C), any amounts invested in eligible tax-exempt bonds under § 1.148-1(c)(4)(ii)(B) must be invested continuously in such tax-exempt bonds to the extent provided in § 1.148-1(c)(4)(ii)(D). Section 1.148-1(c)(4)(ii)(C)(1) provides that amounts previously invested in eligible tax-exempt bonds under § 1.148-1(c)(4)(ii)(B) that are held for not more than

30 days in a fiscal year pending reinvestment in eligible tax-exempt bonds are treated as invested in eligible tax-exempt bonds.

Section 1.148-1(c)(4)(ii)(E) provides that eligible tax-exempt bonds means (1) a bond the interest on which is excludable from gross income under § 103 and that is not a specified private activity bond subject to alternative minimum tax, (2) an interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest on a bond that is excludable from gross income under § 103 and that is not interest on a specified private activity bond subject to the alternative tax; or (3) a certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Section 1.148-10(g) provides that, notwithstanding any specific provision in §§ 1.148-1 through 1.148-11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under § 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or similar circumstances so warrant, consistent with the purposes of § 148.

Section 344.7(b) of the regulations governing State and Local Government Series (SLGS) securities, 31 CFR Part 344, provides that at any time the Secretary determines that issuance of obligations sufficient to conduct the orderly financing operations of the United States cannot be made without exceeding the statutory debt limit, any unredeemed Demand Deposit securities will be invested in special 90-day certificates of indebtedness. Funds invested in the 90-day certificates of indebtedness earn simple interest equal to the daily factor in effect at the time Demand Deposit security issuance is suspended, multiplied by the number of days outstanding. When regular Treasury borrowing operations resume, the 90-day certificates of indebtedness, at the owner's option, are payable at maturity, redeemable before maturity, provided funds are available for redemption, or reinvested in Demand Deposit securities.

ANALYSIS

Situation 1

After the conversion of Issuer A's Demand Deposit SLGS into the Special 90-day C of I, Issuer A's available amounts were no longer invested in eligible tax-exempt bonds. Based on the facts and circumstances, we conclude that the application of § 1.148-10(g) is appropriate and we will treat the Special 90-day C of I as Demand Deposit SLGS for the period during which the issuance of Demand Deposit SLGS was suspended. Therefore, the conversion does not cause Issuer A to fail to meet the continuous investment requirement of the safe harbor for longer-term working capital financings.

Situation 2

After the conversion of Issuer B's Demand Deposit SLGS into the Special 90-day C of I, Issuer B's replacement proceeds were no longer invested in tax-exempt bonds. Nonetheless, based on the facts and circumstances, we conclude that the application of § 1.148-10(g) is appropriate and we will treat the Special 90-day C of I as Demand Deposit SLGS for the period during which the issuance of Demand Deposit SLGS was suspended. Therefore, the conversion does not cause Issuer B's investment to lose its status as a tax-exempt bond.

Please call (202) 317-6980 if you have any further questions.