Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact: 199909043

Telephone Number:

Refer Reply to:
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Date: NOV 24 1998

LEGEND:

Agency =

Bank =

Parent Bank =

State =

Town =

a =

Dear

This letter is in response to your request on behalf of the Bank for a ruling that certain obligations may be treated as "qualified tax-exempt obligations" within the meaning of § 265(b)(3)(B) of the Internal Revenue Code.

Facts:

You make the following representations. The Bank is a bank formed under the laws of the State. The Bank is a member of a consolidated return group, the common parent corporation of which is the Parent Bank. The Agency is a body corporate and politic, established by the State. The Agency's statutory mission is "to buy and sell securities and to make loans to qualified entities."

The Agency, in conjunction with the Bank, plans to establish a new program (the "Program") to assist local government borrowers in the State (the "Local Governments") in financing the acquisition of capital assets (the "Financed Assets"). Under the

Program, the Agency will become the nominal purchaser of the Financed Assets, which assets will then be leased to the Local Governments pursuant to the terms of lease agreements (the "Lease Agreements"). The Bank will provide the funds for the acquisition of the Financed Assets by purchasing the Agency's rights as lessor (including the payment obligations imposed on the Local Governments). Until the Bank provides such funds, however, the Agency is under no obligation to make purchases of Financed Assets under the Lease Agreements. At no time will either the Bank or the Agency take physical possession of the Financed Assets. The Agency will have no interest in the payment stream payable under the Lease Agreements, nor will it have any continuing rights or obligations with respect to any Lease Agreement following the sale to the Bank. The Agency's sole income from each transaction will be a one-time placement fee, received at the closing of each transaction.

For Federal income tax purposes, the Lease Agreements are financing arrangements, and the owners of the Financed Assets will be the Local Governments. Under the Lease Agreements, the Local Governments (and not the Agency) are responsible for executing a Form 8038-G or Form 8038-GC, as applicable, with respect to the Lease Agreements, electing to treat the Lease Agreements as qualified tax-exempt obligations and taking such actions as are necessary under State law to "issue" the Lease Agreements.

The Bank reasonably expects that all of the Lease Agreements will not be "private activity bonds" (as defined in § 141), other than bonds described in § 265(b)(3)(B)(ii). The Bank reasonably expects the principal amount of the Lease Agreements that it will purchase under the Program, when added to the tax-exempt obligations issued by the Agency (other than obligations described in § 265(b)(3)(C)(ii)), will exceed $10,000,000 for the 1998 calendar year.

Under State law, the Lease Agreements entered into by the Local Governments will not be subject to public bidding requirements, because the initial lessor is the Agency. If the Lease Agreements were entered into directly between the Bank and the Local Governments, a public bidding process would be required. Avoiding the public bidding requirements is the primary reason for the involvement of the Agency in the transactions.

Under the Program, each Lease Agreement will be a separate transaction with its own terms, including default and security arrangements. Neither the Agency nor the Bank is obligated to enter into any other Lease Agreement as a result of entering into a Lease Agreement with a particular Local Government.

Specifically, the Bank is free to reject any given Lease Agreement. Only the format and structural terms of the arrangement have been agreed upon; each Lease Agreement stands on its own, with its own interest rate and payment terms. The Bank will perform a separate credit risk analysis for each Lease Agreement and Local Government. The credit risks associated with one transaction will not have an impact on the terms of any other transaction. The Bank is purchasing the Lease Agreements for investment purposes and reasonably expects to hold each Lease Agreement entered into under the Program for a period of at least one year.

The Town is a Local Government participating in the Program. Through the Program, the Town is financing the acquisition of a fire truck with a Lease Agreement (the "Town Lease Agreement") in the amount of $a.

The Town is a "qualified small issuer" within the meaning of § 265(b)(3)(C). If the Bank had purchased the Town Lease Agreement directly from the Town under the terms described above without any involvement of the Agency, the Town Lease Agreement would be eligible to be designated as a qualified tax-exempt obligation.

Ruling Requested:

The Bank has requested a ruling that the Town Lease Agreement is a qualified tax-exempt obligation, notwithstanding the involvement of the Agency under the Program.

Law and Analysis:

Section 265(a)(2) provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income taxes.

Section 265(b)(1) provides generally that in the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest. Section 265(b)(2) provides that the portion of the taxpayer's interest expense which is allocable to tax-exempt interest is an amount which bears the same ratio to such interest expense as (A) the taxpayer's average "adjusted bases" (within the meaning of § 1016) of tax-exempt obligations acquired after August 7, 1986, bears to (B) the average adjusted bases for all assets of the taxpayer.

Section 265(b)(3)(A) provides that any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated as if it were acquired on August 7, 1986. Section 265(b)(3)(B) provides that the term qualified tax-exempt obligation means a tax-exempt obligation which (i) is issued after August 7, 1986, by a qualified small issuer, (ii) is not a private activity bond (as defined in § 141, but excluding bonds described in § 265(b)(3)(B)(ii)), and (iii) is designated by the issuer as a qualified tax-exempt obligation.

Section 265(b)(3)(C)(i) provides in general that the term qualified small issuer means, with respect to obligations issued during any calendar year, any issuer if the reasonably anticipated amount of tax-exempt obligations (other than obligations described in § 265(b)(3)(C)(ii)) which will be issued by the issuer during the calendar year does not exceed $10,000,000.

Section 265(b)(3)(F) provides that in the case of an obligation which is issued as part of a direct or indirect composite issue, such obligation shall not be treated as a qualified tax-exempt obligation unless (i) the requirements of § 265(b)(3) are met with respect to such composite issue (determined by treating such composite issue as a single issue), and (ii) the requirements of § 265(b)(3) are met with respect to each separate lot of obligations which are part of the issue (determined by treating each such separate lot as a separate issue).

The Bank has requested a private letter ruling that the Town Lease Agreement, assigned by the Agency to the Bank under the Program, as described above, will constitute a qualified tax-exempt obligations under § 265(b)(3). The Town Lease Agreement will constitute a qualified tax-exempt obligation if (i) the Town, and not the Agency, is the issuer of the Town Lease Agreement for purposes of the $10,000,000 limit imposed by § 265(b)(3)(C)(i), and (ii) if the Town Lease Agreement is not issued as part of a direct or indirect composite issue.

The Agency is not acting in the capacity of an issuer. In the absence of the actual issuance of some type of obligation or certificate, whether an entity is acting in the capacity of an issuer is based on the facts and circumstances in each case. In this case, the Agency is not issuing any obligation or certificate backed by the Town Lease Agreement and selling it to the Bank. Rather, under the Program, the Agency will become the nominal purchaser of the fire truck, which will then be leased to the Town. The Bank will provide the funds for the acquisition of the fire truck by purchasing the Agency's rights as lessor

(including the payment obligations imposed on the Town) under the Town Lease Agreement. Until the Bank provides such funds, however, the Agency is under no obligation to purchase the fire truck under the Town Lease Agreement. In this capacity, the Agency is simply acting as an intermediary by purchasing the Town Lease Agreement and selling it to the Bank. The Agency has no continuing rights or obligations with respect to any Lease Agreement following the sale to the Bank. The Agency is participating in the transaction solely to avoid a state law public bidding requirement.

The Town Lease Agreement is not issued as part of a direct or indirect composite issue. A composite issue would exist where sales of Lease Agreements to the Bank were made (directly or indirectly) on a pooled basis or where the Bank purchases individual Lease Agreements with the expectation of selling them (directly or indirectly) on a pooled basis. In this case, each Lease Agreement sold by the Agency to the Bank stands on its own, with its own default and security arrangements and its own interest rate and payment terms. The Bank is free to reject any given Lease Agreement. The Bank will perform a separate credit risk analysis for each Lease Agreement and Local Government such that the credit risks associated with one transaction will not have an impact on the terms of any other transaction. The Bank is purchasing the Lease Agreements for investment purposes and reasonably expects to hold each Lease Agreement for a period of at least one year. As such, the Program does not afford participants the benefits of either a large issue or a large issuer.

Conclusion:

We therefore conclude that the Town Lease Agreement is a qualified tax-exempt obligation within the meaning of § 265(b)(3), notwithstanding the involvement of the Agency with the Program.

No opinion is expressed as to the tax treatment of the transaction involved herein under provisions of any other section of the Code and regulations that may be applicable thereto, or the tax treatment of any condition existing at the time of, or effect resulting from, the transaction that is not specifically covered by the above ruling.

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

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: _____
Bruce M. Serchuk
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Enclosure:
Copy for § 6110 purposes