OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated December 7, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

Issuer
Developer 1
Developer 2
Developer 3
Bonds 1
Bonds 2

Bonds 3
A $
B %
C %

| | |
|---|---|
| D | |
| E | |
| F | |
| G | |
| H | |
| I | |
| J | |
| K | $ |
| L | % |
| x | % |
| Maturity Date 1 | |
| Amount 1 | $ |
| Amount 2 | $ |
| Amount 3 | $ |
| Amount 4 | $ |
| Amount 5 | $ |
| Amount 6 | $ |
| Amount 7 | $ |
| Amount 8 | $ |
| Amount 9 | $ |
| Date 1 | |
| Date 2 | |
| Date 3 | |
| Date 4 | |
| Date 5 | |
| Date 6 | |
| Dates 7 | |

ISSUE(S):

1. Whether there are sufficient facts to support an argument that Bonds 2 were a reissuance of Bonds 1?

2. What further factual development is necessary to support an argument that the Bonds 2 are arbitrage bonds?

CONCLUSIONS:

1. There are probably sufficient facts to support an argument that there has been a reissuance of Bonds 1. We want to see some additional facts in this regard. However, more importantly, the focus should be on whether there was an another reissuance when Bonds 2 were sold on the secondary market. We need to "step" the land sale and defeasance with another reissuance. If there was a reissuance,

then we need to determine whether these bonds were obligations under section 103 or arbitrage bonds. More factual development is necessary . We recommend that additional information be provided and a supplemental FSA be requested to determine whether we have sufficient facts to proceed with a technical advice.

2. Additional information is necessary to support an argument that Bonds 2 or Bonds 3 are arbitrage bonds. There are several theories under the arbitrage rules for which we should continue to develop support that these bonds are not tax-exempt, including those principles set forth in Rev. Rul. 94-42, 1994-2 C.B. 15 (stepped transactions/sham/ guarantees) and the reissuance argument. We recommend pursuing these theories rather than the general anti-abuse rules regarding abusive arbitrage devices set forth in the arbitrage regulations. In this case, some facts support an argument that there was a prearrangement of transactions that should be "stepped" together to support a finding of either taxable arbitrage bonds or obligations not qualifying under section 103. We recommend that you further develop this case along the lines set forth below.

<u>FACTS:</u>

<u>First Transaction</u>

On Date 1, the Issuer issued Bonds 1 in the amount of A. The interest rate on a portion of those bonds was B percent. The interest rate on the remaining bonds was C percent. The bonds matured on Date 1. These bonds were callable and interest was due semiannnually. Bond proceeds were to be used to fund the acquisition, construction and installation of
The source of payment for the debt service on the bonds was to be "general annual ad valorem property taxes."[1] The conduit borrower, Developer 1, executed a development agreement whereby it would pay
from to in amount 2. These fees were to be used to pay debt service on the bonds until the property generated the required amount of property taxes. Developer 1 had the right to develop the property and sell
on property it owned within the development area.

On Date 2, Developer 1 defaulted on its obligation to pay the
and declared bankruptcy. The issuer foreclosed on Developer 1's property in the development area since that was the security for its obligations to

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[1] We are unable to tell from this description if the security for these bonds is similar to the pledged property taxes for Bonds 2 or whether there is some general obligation also involved.

the issuer. The Issuer obtained D acres of land. Most of the infrastructure had been completed.

Because Developer 1 defaulted on its obligation to pay the facilities development fees, and no homes had yet been built which could generate property taxes, the issuer could not meet debt service on the bonds. On Date 3, the Issuer filed a Chapter 9 bankruptcy proceeding. On Date 4, the Bankruptcy Court approved the Issuer's (Debtor) plan.

Second Transaction

As part of its bankruptcy plan, the Issuer was to exchange Bonds 1 for Bonds 2. Bonds 2 had a new maturity dates (extended maturity dates beyond that of Bonds 1) and were zero coupon bonds which could not be called before maturity. Bonds 2 were secured by pledged limited tax revenues arising from the development property and the mortgage to the property acquired from Developer 1. If the pledged revenues were not sufficient to pay the principal and interest when the bonds matured, the Issuer would sell the property. At the time of issuance on the Bonds 2, there was still no residences in the development, so no property taxes could be levied.

As part of the plan to exchange Bonds 1 for Bonds 2, the Issuer agreed to pay bondholders E cents on the dollar for Bonds 1 and to exchange Bonds 1 for like amounts of Bonds 2. Developer 2 then offered to pay bondholders F cents on the dollar for their Bonds 2. Bondholders then recouped a total of G cents on the dollar of their original investment. Developer 2 held all of Bonds 2.

Third Transaction

On Date 5, the Issuer purchased H acres of land from Developer 3. Developer 3 had originally purchased the land located in the Issuer's development area for use as residential lots. The Issuer paid Amount 2 and executed notes payable for Amount 3. This amounted to about Amount 4 per acre. The Issuer stated in required documentation that the purchase price paid for the land was not in excess of fair market value. There does not appear to be any question that this was an arms-length transaction.

Fourth Transaction

On Date 6, the Issuer sold approximately I acres of land (including some of land obtained from Developer 1's bankruptcy and its purchase from Developer 3) to Developer 2 for Amount 5. This was about Amount 6 per acre. This was a substantial difference from the amount it recently paid for some of these acres, Amount 4 per acre. The purchaser of the land, Developer 2, was also the bondholder for Bonds 2, and the land sold to it was the underlying security for those bonds. Your office has also found a document, entitled the dated Date 4, (around the time of issuance of Bonds 2) which shows that the Issuer had prior knowledge that it would be selling the land to Developer 2 for a then unknown amount.

Fifth Transaction

The Issuer used the sale proceeds from the land sale to purchase U.S. Treasuries and placed them in an escrow account for the payment of principal and interest on Bonds 2.[2] The amount of the land sale equals the exact amount that is needed to pay off debt service on Bonds 2 at maturity when that amount is invested at the interest rate stated on the bonds.

Sixth Transaction

After the Issuer established the escrow for Bonds 2, Developer 2 sold Bonds 2 in the secondary market, Bonds 3, for Amount 8, realizing a profit of Amount 9. We have no other information regarding the sale of the bonds on the secondary market.

Since the Issuer sold the land to Developer2, there still has been no development or construction of residences. Some of the land has since been sold by Developer 2 to another company owned by Developer 2 for development of J.

LAW AND ANALYSIS

Issue 1.

We agree with your analysis that the facts support an argument that there was a reissuance of Bonds 1. There were significant changes in timing of payments on debt service and the underlying security for Bonds 2. There was an extension of maturity dates on Bonds 2 of and years. Bonds 2 were not callable while Bonds 1 were callable. Bonds 2 were bonds, whereas interest was to be paid on Bonds 1 semi-annually. The security for Bonds 1 was property taxes. The original security for Bonds 2 was pledged property taxes secured by the mortgage to the property in the development area. Within a year of issuance of Bonds 2, they became secured by U.S. Treasuries. You need to provide additional

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[2] According to the agent, the Issuer was also to receive Amount 7 from Developer 2 for the purchase of This amount as well as the amount received from the land sale were actually used to purchase the Treasuries.

information to support that finding. See discussion under case development. But more importantly, you need to focus on whether there has been a reissuance when Bonds 2 were sold on the secondary market. It is this reissuance that is important for arguing that these are arbitrage bonds. The fact that the Issuer sold the land and used the proceeds to purchase the Treasuries (create a defeasance) in and of itself is not necessarily determinitive, but if the defeasance is linked to a reissuance, so that the result is Bonds 3, then it will be easier to establish the arbitrage play or that these are not obligation qualifying under section 103.

Because Bonds 2 were issued prior to Notice 88-130 and the proposed and final regulations under Treas. Reg. § 1.1001-3, guidance was provided in the form of published rulings, private letter rulings, and <u>Cottage Savings Association v. Commissioner</u>, 499 U.S. 554 (1991). The changes discussed above support a reissuance argument under this guidance and under the current regulations. If there was an additional reissuance when the bonds were sold on the secondary market, then the proposed regulations were in effect. We need more information on this transaction before we can assess the strength of this argument. See case development section.

<u>Issue 2</u>

In trying to develop arguments that support the position that Bonds 2 and Bonds 3 were separate issues, with only Bonds 2 as tax-exempt, several theories should be pursued and facts supporting them more fully developed. The principles in Rev. Rul. 94-42 provide guidance, as well as the reissuance rules. [redacted] Furthermore, we disagree with your analysis that the proceeds from the land sale were replacement proceeds and that there was an investment yield of x amount.

Rev. Rul. 94-42 provides that if a transaction, in substance, closely resembles a taxable arbitrage bond, that is, it allows the benefit of borrowing at a tax-exempt rate and investing at a taxable rate, the result will be inconsistent with the purposes of section 103 and the payments will not be treated as payments on a municipal obligation. That ruling provides that amounts paid or accrued under an agreement guaranteeing payment on bonds is not excludable from gross income under section 103 if the agreement is not incidental or is in substance a separate debt instrument or similar investment when purchased. An agreement is considered as both incidental and not a separate debt instrument or similar investment, if at the time it is purchased, the amount paid to obtain the agreement is reasonable, customary, and consistent with reasonable expectation that the issuer of the bonds, rather than the insurer, will pay debt service on the bonds. This rationale applies regardless of whether the agreement acquired the bonds at original issuance or on the secondary market. Although the ruling was not issued until 1994, its principles can be used as support for the position that these are arbitrage bonds or that these bonds are not obligations under section 103.

In the ruling, the County issued zero coupon bonds having a 30 year maturity and a stated redemption price of 204x. The bonds were solely payable from the revenues of the facility acquired with the bonds. At the time, there was significant risk that revenues from the facility would be insufficient to pay debt service.

In an unrelated transaction, one year later, M, the sole holder of the bonds, entered into an agreement with G. Under the agreement, M paid G 14x in exchange for G guaranteeing the payment of all scheduled debt service on the bonds to M or any subsequent holders. G then purchased 14x of U.S. Treasuries, in connection with its agreement with M. The Treasuries had a yield of 9.6%. The Treasuries were transferred to a trust to secure the payment of the bonds. The principal and interest on the Treasuries will be sufficient to pay off all debt service on the bonds. G is unrelated to either the County or M.

The agreement with G allowed M to obtain the highest rating for the bonds from a national rating agency. M then sold the bonds to the general public for a price of $20x, giving the purchasers a annual yield of approximately 8.3%.

In reaching its conclusion, the Service reasoned that the purchasers of the “insured bonds” acquired two obligations from M: the obligation of the County on th bonds and the obligation of G under the agreement. The question is whether amounts paid or accrued under the G agreement are excludable from the bondholders gross income as a substitute for tax-exempt interest.

To make that determination, one must look to the economic substance of the transaction rather than its form. If treating amounts paid under the G agreement would in substance permit either G or M to obtain the benefit of borrowing at a tax-exempt rate and investing proceeds at the taxable rate, then the transaction closely resembles a taxable arbitrage bond under section 148. This purpose is inconsistent with the purposes of section 103, and therefore would not be treated as obligations under section 103.

Although bond insurance or guarantees are allowed in some circumstances, an agreement which is not incidental to the bonds, or that is a separate debt instrument or similar investment, is not permitted for purposes of tax-exemption. If the amount paid for the agreement is reasonable, customary and consistent with the reasonable expectation that the issuer of the bonds, rather than the insurer, will pay debt service on the bonds, then the agreement is considered incidental and not a separate debt instrument or similar investment.

In the ruling, it was determined that the premium paid to G was not reasonable or customary and that M looked primarily to G for payment of debt service on the bonds. As evidence of the reasonable expectations that G rather than the County would make payment on the bonds is M's payment to G of an amount sufficient to fund substantially all of the debt service.

In this case, the economics of the transaction may be similar to the ruling. Zero coupon bonds were issued, initially secured by the pledged property tax revenues, in an area where no have been constructed, making the collection of property taxes improbable. It is very questionable whether property taxes would be sufficient to cover debt service at maturity (Dates 7) since there are still no built to date. No other sinking funds had been established except the escrow of U.S. Treasuries (which was established within one year of issuance of the bonds).

Developer 2 was the sole bondholder. The Issuer sold land in the development to Developer 2 in exchange for money. The amount paid to the Issuer appears to a great deal above the fair market value of the land. In fact, the amount paid by Developer 2 for the land sale equaled the amount necessary to invest at M percent and pay off Bonds 2 at maturity. The Issuer then used the sale proceeds to purchase U.S. Treasuries and placed them in escrow to secure payment of debt service on the bonds. After the Treasuries were placed in the escrow, Developer 2 sold the bonds on the secondary market for a large profit. The payment for debt service on the bonds is reasonably expected to be made from the U.S. Treasuries, and not the pledged property taxes. It is reasonable to conclude that a premium paid by Developer was used to purchase a guarantee for payment on the debt service of the bonds, to enable the bonds to be remarketed which would not have been possible without the guarantee.

We need to establish that these transactions resulted in either the Issuer or Developer 2 benefitting by borrowing at the tax-exempt rate and investing at the taxable rate for finding that we have a taxable arbitrage bond (i.e., what is the yield to the holder if the profits are considered). We could also find that this purpose is inconsistent with the purposes of section 103 and therefore this would not be a municipal obligation under section 103. We also need to determine whether it is reasonable and customary to pay the amount for the guarantee and that it is expected that the Issuer will pay debt service on the bonds. In this case there are some differences that could present some problems. For example, the guarantee for payment on the bonds is possible because of the payment made from Developer 2 to the Issuer. There is no unrelated party involved, as in the ruling. Although the ruling does not require that there be unrelated parties. It may be more difficult to argue that the Issuer is not reasonably expected to pay debt service since the Treasuries were purchased by the Issuer from the sale of its land. If we can establish that there is a reissuance of Bonds 2 to Bonds 3, this may be less of a problem.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Please call If you have any further questions.

By: ______________________________
JOEL E. HELKE
Branch Chief
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