OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated March 2, 1999. 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.

LEGEND:

State =
Association =

Program =
Program Bonds =

Year 1 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
$a =
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c =

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ISSUE(S):

1. Whether several series of Bonds (as defined hereafter) issued by a number of school districts to provide financing to all school districts within a state are arbitrage bonds where the proceeds of the Bonds were placed in a guaranteed investment contract with an earnings rate above the stated interest rate on the Bonds.

2. Whether the six month temporary period under I.R.C. § 148(c)(2)(A) applies where the proceeds of the Bonds are to be used to provide financing to all school districts within a state.

3. Whether the debt service reserve fund was not reasonable due to the existence of a state program that directs appropriations from a defaulting school district to the bondholders of such school district.

4. Whether each series of Bonds issued in an amount less than $5,000,000 meets the small issuer exception for rebate provided in I.R.C. 148(f)(4)(D).

5. Whether the Bonds are subject to rebate as pooled financing issues under the provisions of Treas. Reg. § 1.148-8(d)(1).

6. Whether the Bonds were issued for the purpose of avoiding the $5,000,000 size limitation of I.R.C. § 148(f)(4)(D).

7. Whether the issuance of the Bonds violates the anti-abuse rules of Treas. Reg. § 1.148-10.

8. Whether fees paid to the issuers from the proceeds of the Bonds in return for issuing the Bonds are unspent proceeds.

CONCLUSION:

1. There is insufficient information to determine if the Bonds are arbitrage bonds. To determine the extent, if any, of arbitrage earnings, you must determine the yield on the Bonds and on the investments acquired with bond proceeds. If arbitrage earnings are present or if the issuers reasonably expected to invest bond proceeds in materially higher yielding investments, the Bonds are arbitrage bonds unless one or more exceptions apply.

2. It appears that the six month temporary period under I.R.C. § 148(c) applies because the proceeds of the Bonds are used to finance purpose investments to two or more conduit borrowers.

3. There is insufficient information to determine that the mere existence of the state program renders the reserve fund unreasonable. There is no reference to the program in the Trust Indenture. It is also not clear under what circumstances and how quickly bondholders will be paid. Uncertainty regarding the security for the bonds may justify the existence of a reserve fund.

4. There is a strong argument that the Bonds do not meet the small issuer exception for rebate as it appears that 95 percent or more of the proceeds are not used for local governmental activities of the issuers as required by I.R.C. § 148(f)(4)(D)(III).

5. As the facts suggest the transaction is a pooled financing, the issuers may be subject to the rebate requirement for any unloaned gross proceeds.

6. There are facts suggesting that the Bonds were issued in such a manner as to avoid the size limitations of I.R.C.. § 148(f)(4)(D). The issuers apparently did not receive a substantial benefit from the project. Further, there is evidence that another agency would have issued the Bonds, but for the $5,000,000 size limitation.

7. Additional development is necessary before asserting the anti-abuse provisions of Treas. Reg. § 1.148-10. The argument that an abusive arbitrage device was employed is dependent on the facts and circumstances. Additional facts are necessary to establish that this transaction was motivated by arbitrage.

8. There is insufficient information to determine how the issuers allocated the payments received for issuing the Bonds. However, the amounts may represent proceeds from the sale of the bonds and must be accounted for under Treas. Reg. § 1.148-6.

FACTS:

State statute permits local governmental units (including independent school districts) to exercise their powers jointly with other governmental units in an effort to provide services and facilities on a cost effective basis. State statute also permits governmental agencies to issue negotiable revenue bonds to finance public projects for other governmental agencies. The Association was established pursuant to such statutes.

Specifically, Association was formed for the stated purpose of acting as an issuing agency of bonds and notes to realize the economies of scale inherent in pooled financings. Since its formation in Year 1, Association has served as the issuing agency for approximately $a of equipment lease revenue bonds for numerous school districts in State. The proceeds of the bonds have been used primarily to purchase equipment for participating school districts. Association's operations are controlled by a board of directors.

The Program

State law requires school districts to hire a fiscal agent in order to incur indebtedness. State imposes a fee schedule school districts are required to follow to pay fiscal agents for their services. Association maintains that the fee schedule imposed by States makes it cost prohibitive for many school districts to borrow for small capital projects. Association's Program is purportedly designed to alleviate this problem by providing financing for projects of $b or less at a lower cost of borrowing to school districts.

Rather than acting as the issuing agency for the Program, Association asked c of its member school districts (the "issuing school districts") to each issue bonds in the amount of $d. Each issuing school district agreed that the total bonds issued for the year would not exceed $5,000,000. In addition, each issuing school district agreed to limit tax-exempt borrowings to $5,000,000 in the year in which draws are made from the Program. Association is also the Program Administrator. Among other duties, the Program Administrator reviews applications for financing and services the leases. Association named a third party to act in its behalf as Program Administrator.

All e school districts in State may obtain financing through the Program. The school districts are political subdivisions of State with taxing authority. Funds obtained through the Program are used to finance the cost of acquiring, constructing and equipping school buildings and school facilities.

Because State law requires public approval for loans for capital expenditures, financing under the Program is provided through lease agreements. Upon approval of a request for financing, Association uses bond proceeds to acquire property or construct a project. In turn, the borrowing school district leases the property or project from Association. Lease terms, including lease rental payments, are negotiated by Association with the borrowing school district. Although the Program was ostensibly designed to reduce the costs associated with borrowing $b or less, a school district may participate in the Program regardless of the size of the project to be financed. At least one issuing school district has also borrowed from the Program.

Trust Indenture

Each of the c issuing school districts and Association are parties to a single Trust Indenture (the "Indenture") dated Date 1. The Indenture authorized the issuance of bonds up to an aggregate principal amount of $f. The stated purpose for the bonds is to provide Association with the funds necessary to offer public agencies fixed rate leases at low interest rates. The Indenture provides that the proceeds of each issue are delivered to Association to hold in trust and to be applied for the purposes of the Program as needed

The c issuing school districts issued bonds in a consecutive series each at least 15 days apart, with the first issued Date 2 and the last issued Date 3. Each series is designated as Program Bonds. Each bond series has two components: a $g Convertible Rate portion and a $h Fixed Rate portion.

The Indenture creates several funds including: a) the Project Fund; b) the Revenue Fund; c) the Debt Service Reserve Fund; d) the Cost of Issuance Fund; and e) the Redemption Fund. The proceeds from the Convertible Rate bonds were deposited in the Project Fund and the Cost of Issuance Fund. The proceeds of the Fixed Rate Bonds were deposited in the Debt Service Reserve Fund.

Proceeds are disbursed to Association from the Project Fund to finance the leases under the Program. After the origination of a lease, Convertible Rate Bonds in an amount approximately equal to the lease are tendered and remarketed as Adjusted Rate Bonds on the first specified interest rate adjustment date.

Pursuant to the Indenture, payments due under the leases are deposited in the Adjusted Series Account, a sub-account of the Revenue Fund. Amounts in the Adjusted Series Account are applied to the payment of interest on the Adjusted Rate and Fixed Rate Bonds. Interest on the Convertible Rate Bonds is paid from the Convertible Series Account of the Revenue Fund.

The payment of principal, premium, if any, and interest on each series of Program Bonds is secured solely by the Trust Estate. The Indenture creates and pledges a single Trust Estate as security for the Convertible Rate Bonds. Likewise, a single Trust Estate is pledged and assigned as security for the Adjusted Rate and Fixed Rate Bonds. The issuers assign the Trust Estate to Association, subject to the interests of the Trustee, to be applied for the purposes of the Program.

The Convertible Rate, Adjusted Rate and Fixed Rate Bonds are subject to redemption at the option of Association. Notice of redemption is at the expense of Association. The Remarketing Agreement for the Convertible Rate Bonds is between Association, the Trustee and the Remarketing Agent. The issuing school districts are not a party to the agreement.

The rating for each series of Program Bonds (referred to collectively as the "Bonds") is based on State's Intercept Program which provides that State may withhold appropriations of aid if a school district is unable to meet its debt service. State redirects the appropriations to the bondholders of the defaulting district.

Guaranteed Investment Contract

The proceeds of the Bonds were invested in a guaranteed investment contract (GIC). The parties to the GIC are the Trustee, the GIC provider and Association. The rate of earnings on the GIC is based on an index and was not determined until the issuance of each individual series. It appears, however, that the GIC applies the same formula for determining the rate of earnings for each bond fund. From the information provided, the rate of earnings on the GIC for each bond fund exceeds the stated interest rate on each series of Program Bonds. In addition, a clause in the GIC states that Association covenants to issue the Bonds and establish all funds and accounts relating thereto.

A draw schedule is provided for amounts invested in the GIC. If a borrowing school district requires funds earlier or in excess of the draw schedule, the district incurs a breakage fee. In effect, funds received under the Program are net of the breakage fee.

Each of the issuing school districts apparently received a $i payment from the proceeds of the Bonds. Approximately k lease financing arrangements in the amount of $l had been made under the Program as of Date 4.

Further, the Non-Arbitrage Certificate for this transaction states that whenever any action or direction is required of the issuer, such action or direction may be made by Association.

Finally, you represent that at the time of issuance of the Bonds the parties knew that the proceeds would be invested in higher yielding investments.

## LAW AND ANALYSIS

### 1. Arbitrage Bonds

Section 103(a) of the Internal Revenue Code[1] provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b)(2) provides that subsection (a) shall not apply to any arbitrage bond, within the meaning of section 148.

Section 148(a) of the Code defines the term 'arbitrage bond' to mean 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. Further, section 148(a) provides 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 section 148(a)(1) or (2). The taking of any deliberate, intentional action by the issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional. Treas. Reg. §1.148-2(c).[2] The restrictions

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[1] References to the Internal Revenue Code are to the 1986 Code unless otherwise stated.

[2] Final regulations under section 148 are applicable to bonds issued on or after July 8, 1997. An issuer may apply the provisions of sections 1.148-1 through 1.148-11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954. While it is not clear whether the issuers elected to apply the final regulations, the amendments to the regulations under section 148 do not impact the analysis provided in this memorandum.

on arbitrage apply to all state and local bonds unless the bonds meet one or more of the enumerated exceptions to yield restriction or rebate rules.

Treas. Reg. § 1.148-2(a) provides that direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. "Gross proceeds" is defined in Treas. Reg. § 1.148-1(b) as any proceeds and replacement proceeds of an issue. "Proceeds" is defined as any sale proceeds, investment proceeds, and transferred proceeds of an issue. Treas. Reg. § 1.148-1(b).

Section 148(b)(1) of the Code defines the term 'higher yielding investments' to include any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue. Under Treas. Reg. § 1.148-2(d)(2)(i), the term “materially higher” generally means one-eighth of 1 percentage point (.125 percent).

Generally, the yield on an issue of bonds is computed under the economic accrual method using any consistently applied compounding interval of not more than one year. Bond yield is interpreted to mean the discount rate at which all anticipated payments of principal and interest on the bonds equals the issue price after deducting certain costs of issuance. Treas. Reg. § 1.148-4(b)(1)(i). Rules for computing yield on fixed yield issues and variable yield issues are set forth in Treas. Reg. § 1.148-4 subparagraphs (b) and (c), respectively. The yield on an investment allocated to an issue is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. Treas. Reg. § 1.148-5(b).

As stated, the proceeds from the Bonds were invested in a GIC. The interest rate on the GIC was based on an index rate and was apparently not established until issuance. However, the GIC rate of earnings for each bond fund proved to be higher than the stated interest rate on the corresponding Program Bonds. While this may suggest the existence of arbitrage earnings, the stated interest rate on each series of Program Bonds may differ from its yield. It is the yield on an issue of bonds that is used to apply investment yield restrictions and rebate liability. Treas. Reg. § 1.148-4(a). The information provided does not contain an analysis of the yields on the Bonds or of the yield on the GIC acquired with bond proceeds. Such analysis must be made in order to determine the extent, if any, of arbitrage earnings. To assist with the computation of yield on the Bonds and the investments, the bond documents will typically contain a debt service schedule showing the total principal and interest payments on the issue.

It is also represented that the parties to this transaction expected that the proceeds of the Bonds would be invested in higher yielding investments. This fact, if supported by independent evidence, would establish that the bonds are arbitrage bonds unless a specific exception to yield restriction or rebate applies. From the information provided, however, it is unclear how this expectation was determined. For instance, the earnings rate on the GIC was based on an index and was not known prior to the issuance of the Bonds. This is not to state, however, that the lack of certainty regarding the rate on the GIC at the time of issuance precludes an expectation that the proceeds would be invested in materially higher yielding investments. In fact, the examination may reveal that this transaction is not economically viable but for the existence of arbitrage earnings. There is simply insufficient evidence available at this point, however, to reach such a conclusion.

2. Temporary Period Exception

Section 148(c)(1) provides that a bond shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such bond is a part may be invested in higher yielding investments for a reasonable temporary period until such proceeds are needed for the purpose for which such issue was issued. The temporary period, however, shall not exceed 6 months with respect to the proceeds of an issue which are to be used to make or finance loans (other than nonpurpose investments) to 2 or more persons. I.R.C. § 148(c)(2)(A). Treas. Reg. § 1.148-2(e)(4) further provides that the proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of 6 months while held by the issuer before being loaned to a conduit borrower.

A pooled financing issue, for purposes of sections 103 and 141 through 150, means an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers. Treas. Reg. § 1.150-1(b). Conduit loan means a purpose investment as defined in section 1.148-1. The term purpose investment is defined as an investment that is acquired to carry out the governmental purpose of an issue. Treas. Reg. § 1.148-1(b).

The stated purpose for each series of Program Bonds is to provide financing to school districts within State. The financing is structured as a lease to avoid State restrictions on public loans. Regardless of the form employed, in substance, the Program provides funds for capital expenditures to the borrowing school districts. Moreover, the leases are purpose investments as defined by the regulations. Consequently, the proceeds of the Bonds were used to finance purpose investments to two or more conduit borrowers. Therefore, it appears that

the 6 month limitation on the temporary period for pooled financings is applicable in the instant case. As a result, proceeds in the Project Fund that were not allocated to purpose investments after 6 months may be subject to yield restriction.

To qualify for the temporary period, Treas. Reg. § 1.148-2(e)(4)(i) also requires a reasonable expectation that the proceeds of the pooled financing issue will be used to finance purpose investments. The issuers' expectations in this case are not readily apparent. For example, although a number of leases have been financed through the Program, the borrowing school districts incur a breakage fee if funds are disbursed from the Proceeds Account earlier than the draw schedule stated in the GIC. There is no indication as to whether a market analysis was conducted to determine the demand within State for this type of financing. Thus, it is unclear if the draw schedule was established to coincide with the number of expected financings or whether the GIC merely restricts the use of funds to maximize arbitrage earnings. Accordingly, there is a concern that the issuers did not reasonably expect to use proceeds for purpose investments within the meaning of section 1.148-2(e)(4)(i).

As an additional point, the temporary period for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans is 3 months. I.R.C. § 148(c)(2)(B). Thus, if payments received under the leases are to be used to finance additional leases, the temporary period for such proceeds will be only 3 months.

Finally, regardless of the applicable temporary period, bear in mind that arbitrage earnings must still be rebated unless a specific exception to rebate applies.

3. Reserve Fund Exception

Section 148(d)(1) of the Code provides that a bond shall not be treated as an arbitrage bond solely by reason of the fact that an amount of proceeds of the issue of which such bond is a part may be invested in higher yielding investments which are part of a reasonably required reserve or replacement fund. As discussed in the context of temporary periods, the fact that yield restriction is not required does not relieve an issuer from its responsibility to rebate earned arbitrage as required under section 148(f).

Section 148(d) and the regulations thereunder establish sizing and funding tests for reasonably required reserve and replacement funds. If the sizing and funding restrictions are met and the reserve or replacement fund is "reasonably

required," bond proceeds placed in the fund may be invested at a yield above the bond yield without causing the issue to be an arbitrage bond. However, the use of bond proceeds for any reserve or replacement fund in excess of that permitted will cause the bonds to be arbitrage bonds.

For example, section 148(d)(2) provides that a bond issued as part of an issue will be treated as an arbitrage bond if the amount of the proceeds from the sale of that issue which is part of any reserve or replacement fund exceeds 10 percent of the proceeds of the issue (or such higher amount which the issuer establishes is necessary to the satisfaction of the Secretary). Treas. Reg. § 1.148-2(f)(2)(ii) further provides that the amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue. For a reserve or replacement fund that secures more than one issue, the size limitation may be measured on an aggregate basis.

The legislative history of section 148(d)(2) does not describe the reason for limiting a reserve fund to 10 percent of the proceeds of an issue of bonds. The limitation, however, is included as part of the arbitrage restrictions and acts to prevent an overissuance of bonds. A primary purpose for the restrictions on arbitrage is to prevent overburdening the tax-exempt market.[3]

Neither the Code nor the regulations provide a definition of a reserve fund. Treas. Reg. § 1.148-2(f)(1). There is also no definition of the term in the legislative history of this provision. The common meaning of a reserve fund, however, includes a fund held by a trustee to provide security to bondholders in the event of an unexpected expense or unforeseen occurrence causing an interruption in the flow of revenues used to pay principal or interest on the bonds. Glossary of Public Finance Terminology (David A. Franklin and James J. Predergast eds., New York: Packard Press, 1990).

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[3] Hearings on H.R.15414 Before the Senate Committee on Finance, 90th Cong., 2d Sess. at 90-91 and 96 (letter from Assistant Secretary Surrey to The Honorable Russell B. Long, Chairman, Senate Finance Committee, testimony of S. Surrey) 1968 (the "1968 Hearings"'); 113 Cong.Rec. 31612 and 31613 (1967) (statement of Sen. Ribicoff).

Pursuant to the terms of the Indenture, 10 percent of the proceeds from each series of Program Bonds were deposited in a reserve fund. On its face, this appears to meet the funding limitations of Treas. Reg § 1.148-2(f)(1). However, gross proceeds in the reserve fund may also not exceed the limitations in Treas. Reg. § 1.148-2(f)(2)(ii) described above. There is no indication as to whether there has been compliance with this provision. Accordingly, it is premature to conclude that proceeds in the reserve fund are not subject to yield restriction.

In addition, there is an issue as to whether the reserve fund was reasonably required for the payment of debt service on the Bonds. The Bonds are revenue bonds secured by the lease payments received from school districts borrowing under the Program. Nonetheless, the Bonds are purportedly rated based on State's Intercept Program. This program, as discussed, provides a mechanism for withholding appropriations from a school district that is unable to meet its debt service requirements and redirecting such appropriations to the holders of that district's debt. These factors suggest that the Bonds have an element of security not associated with the typical revenue bond.

However, the Indenture requires the establishment of the reserve fund. Moreover, the Indenture does not identify the Intercept Program as a means of security for the bonds. In addition, the mechanics of the Intercept Program are unclear. For example, there is no way to determine the point at which the State steps in to withhold appropriations form a defaulting district or even whether the State's obligation to act is unconditional. Further, there is no indication as to the delay, if any, expected between the default of a school district and the receipt of payments by a bondholder under the Intercept Program. Any uncertainty regarding the payment of bondholders under the Intercept Program coupled with the fact that the Indenture requires the establishment of the debt service reserve fund would support the argument that the fund is reasonably required.

4. Small Issuer Exception

Under section 148(f), a bond that is part of an issue is treated as an arbitrage bond unless rebate is paid to the United States by the issuer in a timely manner. Generally, the amount that must be paid is equal to the excess of the amount earned on all nonpurpose investments over the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue. I.R.C. § 148(f)(2).

Section 148(f)(4)(D) provides an exception to rebate for governmental units issuing $5,000,000 or less of bonds. Specifically, section 148(f)(4)(D)(i) provides

an issue shall, for purposes of this subsection, be treated as meeting the requirements of section 148(f) if --

> (I) the issue is issued by a governmental unit with general taxing powers,
>
> (II) no bond which is part of such issue is a private activity bond,
>
> (III) 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and
>
> (IV) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such unit during the calendar year in which such issue is issued is not reasonably expected to exceed $5,000,000.

As stated, the c issuing school districts each issued Program Bonds in the amount of $d, which amount is less than the $5,000,000 limitation specified in the statute. Each school district agreed that the total bonds issued for the year would not exceed $5,000,000. The school districts are all political subdivisions with taxing powers. The proceeds from the Bonds are used to finance the leasing arrangements under the Program. As a result, proceeds from the Bonds may be spent in virtually any school district within State.

The immediate question is whether 95 percent or more of the net proceeds of the issues are used for local governmental activities of the issuers required by section 148(f)(4)(D)(III). Neither the section 148(f) nor the applicable regulations define the term “local governmental activities.” Statutes, however, are to be construed so as to give effect to their plain and ordinary meaning. United States v. American Trucking Associations, 310 U.S. 534, 543-544 (1940).

The plain language of the provision suggests that the term "local governmental activities" refers only to activities entirely within the jurisdiction of the issuer. There is nothing in either the statute or the regulations that evidences an intent to apply the exception to situations where more than 5 percent of the proceeds are used beyond the geographic area of the small issuer. In addition, the term "state" is repeatedly used throughout sections 103 and 141 through 150 in situations where Congress intended a provision to apply to a more broadly defined political unit. A narrow interpretation of "local governmental activities" is consistent not only with the focus of section 148(f)(4)(D) on small issuers, but also with the general rules limiting permissible arbitrage. Therefore, since this transaction is structured so that the majority of the proceeds will be used for the governmental

purposes of the borrowing school districts, there is a substantial argument that the Bonds do not satisfy the requirements of section 148(f)(4)(D)(i)(III).

5. Pooled Financings

As discussed in the context of the temporary period exception, it appears that each of the Bonds are a pooled financing issue in that the proceeds are used to finance purpose investments representing conduit loans to two or more conduit borrowers. Treas. Reg. § 1.150-1(b). The regulations under the small issuer exception to rebate indicate that the issuer of a pooled financing issue, rather than the conduit borrower, is generally subject to rebate.

Specifically, Treas. Reg. § 1.148-8(d)(1) provides that to the extent that an issuer of a pooled financing is not an ultimate borrower in the financing and the conduit borrowers are governmental units with general taxing powers and not subordinate to the issuer, the pooled financing is not counted towards the $5,000,000 size limitation of the issuer for purposes of applying the small issuer exception to its other issues. The regulation further states that the issuer of the pooled financing issue is, however, subject to the rebate requirement for any unloaned gross proceeds.

The cited regulation supports the position that the individual issuers are subject to rebate for arbitrage earned prior to providing financing to the borrowing school districts under the Program. Arguably, a per se rule that the issuer of a pooled financing issue is subject to rebate is consistent with section 148(f)(4)(D)(i)(III) which requires 95% of proceeds to be used for local governmental activities in order to meet the small issuer exception.

6. Aggregation Rules

For purposes of applying the $5,000,000 size limitation under subclause (IV) of section 148(f)(4)(D)(i), rules are provided for aggregating issuers in certain circumstances. Specifically, section 148(f)(4)(D)(ii)(IV) provides that (IV) an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of such subclause (IV) and all other entities benefitting thereby shall be treated as 1 issuer.

Situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer--

> (A) Issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity; and
>
> (B) Does not receive a substantial benefit from the project financed by the bonds. Treas. Reg. § 1.148-8(c)(2)(iii).

Association was formed for the purpose of acting as an issuing agency of bonds and has, in fact, issued approximately $a of equipment lease revenue bonds for numerous school districts in State. Rather than act as the issuer for the Program, Association asked c of its member school districts to each issue bonds in the amount of $d. Despite not acting as the issuing agency, however, the facts indicate that Association maintained a significant level of control over this transaction. Association was a party not only to the Indenture, but also the GIC and the Remarketing Agreement. Under the Indenture, the issuers assign the Trust Estates for the Convertible Rate Bonds and the Adjusted Rate and Fixed Rate Bonds to Association to be applied for the purposes of the Program. The Bonds are subject to redemption at the option of Association. Association also was named as the Program Administrator, although it retained a third party to act in this capacity. Moreover, the GIC provides that Association covenants to issue the Bonds and in conjunction therewith establish all funds and accounts relating thereto. Finally, the Non-Arbitrage Certificate states that whenever any action or direction is required of the issuer, such action or direction may be made by Association.

In contrast, the issuing school districts appear to have few, if any, rights or obligations with respect to the financing. In addition, it does not appear that the issuers receive a significant benefit from the issuance. In fact, other than the $i received for their participation in the Program and, ostensibly, the right to borrow funds from the Program, there is no obvious benefit to the issuers apart from the exception to rebate afforded by section 148(f)(4)(D).

There is no clear indication as to why Association did not act as the issuing agency for the Bonds. Considering the degree of control Association maintained over this transaction and the apparent lack of a substantial benefit to the issuing school districts other than the retention of arbitrage earnings, there is a meritorious basis for asserting that the financing structure under examination was employed to avoid the size limitations of section 148(f)(4)(D)(i)(IV).

Alternatively, there is also a question as to whether the Bonds are, in fact, a single issue as opposed to c separate issues that potentially qualify for the small issuer exception to rebate.

Treas. Reg. § 1.150-1(c)(1)[4] provides that the term issue means two or more bonds that meet all of the following requirements:

(i) Sold at substantially the same time. The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart.

(ii) Sold pursuant to the same plan of financing. The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally--

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) Payable from the same source of funds. The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

From the information provided, it appears that the Bonds were sold pursuant to the same plan of financing and are payable from the same source of funds. The proceeds from the Bonds were delivered to Association to implement the Program. The issuing school districts did not have use of the proceeds other than as potential borrowers from the Program. Moreover, the Bonds were all issued under the same Indenture. It appears that the Bonds are cross-collateralized in that there is a single Trust Estate for the Fixed Rate Bonds and a single Trust Estate for the Convertible Rate Bonds. Payments under the leases are the source of payment for the Bonds.

The Bonds, however, were all issued at least 15 days apart which questions whether they were sold at substantially the same time as contemplated by the regulation. There is no stated purpose for issuing the Bonds at least 15 days apart.

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[4] Section 1.150-1 is generally applicable to bonds sold on or after July 8, 1997. Prior to amendment by T.D. 8718 (May 9, 1997), this section was designated as Treas. Reg. § 1.150-1T(c)(1). The definition provided in the final regulation, however, is substantially the same as that stated in the earlier provision.

Arguably, this was done to avoid the definition of a single issue provided in the regulations. Treas. Reg. § 1.150-1(c)(5) provides, in pertinent part, that bonds may be treated as part of the same issue to clearly reflect the economic substance of a transaction. This anti-abuse rule is intended to prevent the avoidance of sections 103 and 141 through 150. Unless a legitimate reason for issuing the Bonds at least 15 days apart is provided, there is an argument that the anti-abuse rule should apply and the Bonds should be treated as a single issue. Such a determination would result in a single issuance in the amount of $f, rather than c separate issues that potentially qualify for the small issuer exception to rebate.

7. Anti-Abuse

Treas. Reg. § 1.148-10(a) generally provides that bonds of an issue are arbitrage bonds under section 148 if an "abusive arbitrage device" is used in connection with the issue. Furthermore, section 1.148-10(a) provides that paragraph (a) of section 1.148-10 is to be applied and interpreted broadly to carry out the purposes of section 148, as further described in section 1.148-0 of the regulations.

Treas. Reg. § 1.148-10(a)(2) generally defines abusive arbitrage device as any action that 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.

Treas. Reg. § 1.148-10(a)(4) generally provides that an action overburdens the tax-exempt bond market 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 purpose of the bonds, based on all the facts and circumstances. Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion (as defined in section 148(e)) the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under Treas. Reg. § 1.148-2(e)(4).

As stated, there is no indication that either Association or the issuers determined the market demand for this financing arrangement. While a number of school districts have participated in the Program, it appears that only $l worth of loans had been made as of Date 4. This may be due, in part, to the fact that the

GIC restricts the amount of proceeds that may be used for purpose investments without incurring a breakage fee. Restrictions on the use of proceeds invites speculation as to whether the Bonds qualify for the temporary period within the meaning of section 1.148-2(e)(4). Failure to qualify for the temporary period may provide evidence of an early issuance.

An argument that an issuance of bonds constitutes an abusive arbitrage device is highly dependent on the facts and circumstances. While there are certainly facts present that question the parties' motivation for entering this transaction, it is not clear that the case has been developed to the point to assert the anti-abuse provision. As discussed, even the extent of arbitrage earnings has yet to be determined in this case. Without even this threshold determination, we cannot conclude that this transaction was motivated by arbitrage.

8. Fees Paid to Issuers

Treas. Reg. § 1.148-1(b) defines the term "gross proceeds" as the proceeds and replacement proceeds of an issue. The term "proceeds" as any sale proceeds, investment proceeds, and transferred proceeds of an issue. "Sales proceeds", in turn, are amounts actually or constructively received from the sale of a bond issue, including amounts used to pay underwriting discount and issuance costs, and accrued interest.

Each of the c school districts issuing bonds pursuant to the program received a $d fee, which amounts were purportedly paid from bond proceeds. It appears such amounts constitute sales proceeds.

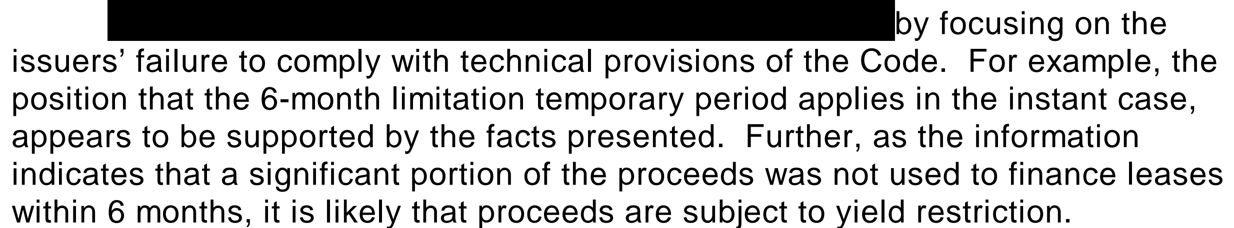
Treas. Reg. § 1.148-6(a) requires gross proceeds to be either spent or invested. It is unclear how the payment to each issuer was allocated. Presumably, the issuer would deposit such amount in its general fund to finance operating expenses. Generally, current operating expenses are working capital expenditures. Treas. Reg. § 1.150-1(c)(3). Treas. Reg. § 1.148-6(d)(3) provides that, in general, the issuer can allocate gross proceeds to expenditures for working capital only under a "gross-proceeds-spent-last" method.

The issuers' treatment of the fees paid to issue the Bonds is speculative at this point. There is a valid concern that such amounts may have not been properly allocated and, thus, remain unspent. Due to the relatively small amount concerned, however, this should be a secondary issue to the other arguments addressed in this memorandum.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Numerous issues have been identified that merit development.

by focusing on the issuers' failure to comply with technical provisions of the Code. For example, the position that the 6-month limitation temporary period applies in the instant case, appears to be supported by the facts presented. Further, as the information indicates that a significant portion of the proceeds was not used to finance leases within 6 months, it is likely that proceeds are subject to yield restriction.



We note, however, that even in the event that proceeds are subject to yield restriction, the issuers may be able to rectify this problem through yield reduction payments permitted under section 1.148-5(c)(3)(i)(A). Yield reduction payments may also be used if there is a determination that the issuers failed to satisfy the size limitation in section 1.148-2(f)(2)(ii) for a reasonably required reserve fund. Treas. Reg. 1.148-5(c)(3)(ii)(E). There is no indication, however, that the issuers have made such payments.

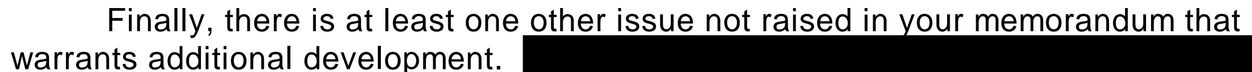
With respect to the argument that the Bonds fail to meet the small issuer exception to rebate because 95% proceeds of the bonds were not used on "local governmental activities," moderate litigation hazards exist. As discussed, there is neither published guidance nor legal authority interpreting the term "local governmental activities." However, given the clear language of the statute and the

intent to limit, rather than expand, permissible arbitrage transactions, it is our opinion that this position would be defensible in litigation. The risk, however, is that the term "local" is clearly subject to interpretation. The term may be interpreted by a court to include an entire area in State within which the small issuer has authority to lend funds.

The argument that the issuers are subject to rebate under the pooled financing rules of section 1.148-8(d) probably carries the least litigation risk of the issues discussed. The provision states that the issuer of the pooled financing issue is subject to the rebate requirement for any unloaned gross proceeds. The ever present litigation risk, however, is that a narrow reading of the provision may suggest that the rebate requirement imposed by this regulation does not apply where the issuer is also a conduit borrower in the pooled financing. Such an interpretation would apparently impact at least one current examination. Even this narrow interpretation of the regulation does not result in a rebate exception for the issuer. Rather, it would simply mean that the regulation could not be relied upon exclusively for the determination that the issuer was, in fact, subject to rebate based solely upon its status as the issuer of a pooled financing bond.

The position that the Bonds were issued in such a manner as to avoid the size limitations of section 148(f)(4)(D) will involve at least a moderate litigation hazard. The determination that the issuers did not receive a substantial benefit from the project and that another agency would have issued the bonds, but for the $5,000,000 size limitation are factual determinations that are subject to interpretation by a court. That stated, it is our opinion that facts have been presented that warrant the development of this issue.

Finally, there is at least one other issue not raised in your memorandum that warrants additional development.



If you have any further questions, please call (202) 622-7870.

By: ______________________________
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