OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
April 18, 2000

Number: **200030003**
Release Date: 7/28/2000
CC:DOM:FS:FI&P
TL-N-5272-99
UIL: 148.00-00; 149.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Credit Enhanced Bonds

This Field Service Advice responds to your memorandum dated January 11, 2000. 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:

Development	=
Town	=
Districts	=
State	=
District A	=
District B	=
Authority	=
Individual X	=
Individual Y	=
Appraiser	=
Corporation 1	=
Corporation 2	=

Corporation 3	=
Corporation 4	=
Corporation 5	=
Limited Partnership	=
City	=
Bonds	=
Class A REMIC Bonds	=
Class B REMIC Bonds	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Date 1	=
Date 2	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=
<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=
<u>k</u>	=
<u>l</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>p</u>	=

ISSUES:

1. Whether the issuance of bonds was structured in such a manner that it was expected that the credit enhancement provider would pay the debt service on the bonds rather than the issuer.

2. Whether the credit enhancement for the bonds, which is secured by lease payments received from a United States agency, creates an indirect federal guarantee of the bonds.

3. Whether the issuance of bonds was an abusive arbitrage device that overburdened the market for tax-exempt bonds.

CONCLUSION:

1. Based on the facts provided, it appears that the credit enhancement provider, rather than the issuer, would pay the debt service on the bonds. Such arrangement may be inconsistent with the purposes of section 103 of the Internal Revenue Code.

2. The credit enhancement for the bonds is secured by lease payments received from a United States agency. The arrangement appears to create an indirect federal guarantee of the bonds.

3. There is an argument that the bond issuance overburdened the market considering the amount of bonds that have been issued without a clear governmental purpose. We recommend additional development before asserting this position, however.

FACTS:

Background

The Development is located in Town. In Year 1, Districts were organized to provide water, sewer, street, park, safety, and recreation improvements within the Development. Districts are quasi-municipal corporations created under the laws of State and are political subdivisions.

The preparation and approval of a service plan is a requirement under State statute for the organization of a District. The service plans for each District consist of a financial and engineering survey showing how proposed services are to be provided and financed.

In Year 2, District A filed for bankruptcy protection under Chapter 9 of the United States Bankruptcy Code after it defaulted on general obligation bonds it had issued in the amount of $a. In connection with District A' s subsequent reorganization, Corporation 1 purchased from District A b acres of property within Development for $c, or approximately $d per acre. Individual X is the sole owner of Corporation 1. Further, Individual Y is a Vice President of Corporation 1 and a director of each of the Districts.

District A originally acquired the property that was sold to Corporation 1 by foreclosing on a lien against the original developer of the Development. The original developer acquired the property, e acres, in Year 3 for less than $f per acre. The purchase price for the property was determined by Appraiser, an independent appraiser.

As a result of the events culminating in District A's bankruptcy, each of the Districts and Town executed an agreement requiring each District to submit an amendment to its service plan outlining its anticipated development before beginning any future development within Development. Town will not formally consider amendments to any District's Service Plan until all Districts amend their service plans.

The Current Transaction

Authority was organized in Year 4 under State law as a nonprofit corporation to further the purposes of District B. Authority is authorized to issue bonds and other obligations payable from the revenues of the Authority. Individuals X and Y are members of the board of directors of Authority.

On Date 1, Authority issued the Bonds. The Bonds were issued for the purpose of acquiring real property upon which Authority purportedly intended to construct certain public improvements, including a golf course and recreational facilities. In fact, proceeds were used to acquire g acres of land and water rights within the Development from Corporation 1 for $h, or approximately $i per acre. At the time of the acquisition, Corporation 1 was the owner of approximately j% of the property within the Development. The purchase price for the property was also determined by Appraiser.

The Bonds are limited obligations of Authority payable solely from funds held under the Indenture (including capitalized interest deposited from the proceeds of the Bonds), revenues of the Authority and payments made under a credit enhancement. Revenues include all income, rents, receipts, and profits of the Authority. The offering documents for the Bonds, however, indicate that revenues were expected to consist primarily of amounts generated by the operation of a golf course.

In connection with the issuance of the Bonds, the Districts also entered into the Operating Agreement and the Intergovernmental Agreement obligating the Districts to provide funds to District B for payment to Authority to the extent that its revenues are insufficient to pay debt service on the Bonds. Such funds would be derived from a mill levy that is subject to certain limitations, including a k mill limitation on taxable property within the Districts. However, the Operating Agreement and the Intergovernmental Agreement do not become effective until an amendment to the Districts' service plans authorizing the mill levy is approved by the Town, or the Districts receive an opinion of counsel that the mill levy may be imposed without regard to any service plan amendment.

Authority also entered into the Development Agreement with Corporation. The Development Agreement provides that, until the mill levy described in the Operating Agreement and the Intergovernmental Agreement is imposed, development charges will be assessed on the property Corporation owns in Development. Such charges are to equal the amount which would be generated by a mill levy against all of the taxable property in the Districts. The charges to be imposed by the Authority, however, are determined by its board of directors. Your memorandum indicates that no payments have been received from Corporation under the Development Agreement.

Prior to issuing the Bonds, Authority obtained a market analysis and revenue projection with respect to the planned golf course and the residential development of the Districts. The analysis, performed by Appraiser, concluded that projected revenues are expected to be sufficient to pay debt service on the Bonds. Appraiser based its conclusions on the assumption that Town will grant required zoning changes in a timely manner.

The purchase price for the sale of the property to Authority was determined by using the market analysis described above. As there has been no development of the property and few, if any, comparative sales, the price was calculated by considering the highest and best use of the property in Development. This appraisal takes into account cash flow from the facilities Authority expected to construct. In contrast to this valuation, you indicate that District A acquired l acres within Development in Year 5 for $m per acre.

At the time of issuance, Authority had not obtained any of the necessary permits or zoning changes to construct the golf course or other recreational facilities. Consequently, the offering memorandum for the Bonds discloses that if those facilities are not completed, there will be no revenues for the payment of debt service. Further, the offering memorandum states that if the golf course and recreational facilities are built, but the residential development is not completed, then the amount of revenues collected by the Districts could be insufficient to pay debt service on the Bonds.

Your memorandum indicates that Town has not approved amendments to any of the Districts' service plans and, as recently as Year 6, Town was not even considering amendments to any service plan. No infrastructure construction has begun in Development. At the present time there are no material contracts with respect to the development of the Project. Moreover, substantial additional financing would have to occur to commence construction.

The Credit Enhancement

As stated, the Indenture for the Bonds provides that the payment of principal and interest on the Bonds should be credit enhanced by Corporation 2. Corporation 2 commenced operation on Date 1, for the purpose of providing the credit enhancement on the Bonds. Corporation 2 is a wholly owned subsidiary of Corporation 3. Individual X is the president of Corporation 2 and owns n% of Corporation 3.

Under the Credit Enhancement Agreement between Corporation 2 and Authority, Corporation 2 guaranteed payment of the Bonds from Date 2 until maturity or redemption. The Indenture provides that all payments of principal and interest on the Bonds (except for interest for the period prior to Date 2) shall be made from the proceeds of draws on the credit enhancement. A portion of the Bond proceeds funded a debt service reserve fund sufficient to meet debt service payments until the time the credit enhancement became effective. Upon issuing the Bonds, the Authority paid Corporation 2 a $o fee for the credit enhancement, which amount equals 6% of the Bond proceeds. Corporation 2 turned the fee over to Corporation 3.

Corporation 4 was formed solely to purchase certain loans from its parent company, Corporation 3, and to issue its real estate mortgage investment conduit bonds ("REMICS"). Corporation 4 is wholly owned by Corporation 3 and commenced its operations on Date 1 by issuing its Class A REMIC Bonds and its Class B REMIC Bonds (together with the Class A REMIC Bonds, the "REMIC Bonds"). The REMIC Bonds are payable from notes secured by lease payments constituting a general obligation of the United States.

The proceeds from the Class A REMIC Bonds were used to make loans to Limited Partnership to construct an office building in City. Your memorandum indicates that Individual X also used the proceeds from the sale of land to the Authority to finance construction of the building in City. Limited Partnership issued notes with respect to the loans received. Limited Partnership is the owner of the office building. Corporation 5 holds a 50% interest in Limited Partnership. Individual X and family members own 100% of Corporation 5.

Limited Partnership entered into a 20 year lease of the office building with a United States agency, acting by and through the General Services Administration (the “Government Lease”). Limited Partnership assigned the payments under the lease to Corporation 4 as collateral for the construction loans. The notes and lease agreement received from Limited Partnership provide the security for the REMIC Bonds. Payments under the Government Lease begin on Date 2. Such payments are sufficient to pay principal and interest on the REMIC Bonds.

In exchange for all its no-par value stock, Corporation 2 acquired the Class B REMIC Bonds from Corporation 4. To secure its obligations under the Credit Enhancement Agreement with Authority, Corporation 2 then pledged and delivered to the trustee for the Bonds the Class B REMICS.

A credit rating agency stated that the Bonds and the REMIC Bonds are secured ultimately by the U.S. Government’s obligation to make payments under the Government Lease. The coupon rates and maturities on the Bonds are similar to the those on the Class B REMIC Bonds.

The offering memorandum for the Bonds provides that it is a condition to issuance of the Bonds that counsel for the United States render an opinion that the obligation under the lease constitutes an absolute and unconditional obligation of the United States. In the event any payments that are due under the lease are not made, Limited Partnership or the trustee would be entitled, in the opinion of counsel for the government, to enforce the payment obligations of the United States in accordance with the terms of the Lease.

Finally, from Date 2, all payments of principal and interest on the Bonds has apparently been made from draws on the credit enhancement. Authority is required to reimburse Corporation 2 for amounts paid under the Credit Enhancement Agreement, but has currently not done so as it has no source of revenues.

LAW AND ANALYSIS:

1. Rev. Rul. 94-42

Section 103(a) of the Internal Revenue Code[1] provides that gross income does not include interest on any state or local bond. Treas. Reg. § 1.103-1 provides that interest on obligations of a state, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof is not includable in gross income except as otherwise provided.

The exclusion from gross income of interest on obligations of states and political subdivisions thereof is not all-embracing and applies only where consistent with the purposes of section 103. See, United States Trust Co. of New York v. Anderson, 65 F.2d 575, 579 (2d Cir. 1933). An overriding purpose of section 103 is to enable state and local governments to borrow at subsidized interest rates to carry out governmental purposes. Rev. Rul. 94-42, 1994-2 C.B. 15.

Further, Rev. Rul. 94-42 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 only if, at the time it is purchased, the amount paid to obtain 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.

In Rev. Rul. 94-42, a County issued zero coupon bonds having a 30 year maturity and a stated redemption price of $204x. The bonds were payable solely from the revenues of the facility acquired with the bonds. At the time of issuance, there was significant risk that revenues from the facility would be insufficient to pay debt service.

In an unrelated transaction, 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

---

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

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 an annual yield of approximately 8.3%.

Rev. Rul. 94-42 held that treating amounts paid or accrued under the G agreement as excludable from gross income would be inconsistent with the purposes of section 103. 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. Id.

While the facts of the instant case do not fit squarely within those described in Rev. Rul. 94-42, the information provided calls into question the economic substance of this transaction. It is axiomatic that the economic substance of a transaction, rather than its form, governs for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). The characterization of a transaction by the parties is not determinative for Federal tax purposes. Paulsen v. Commissioner, 469 U.S. 131 (1985).

First, it is questionable whether any of the parties to this transaction expected Authority to generate sufficient revenues to pay the required debt service on the Bonds. To this day, there is doubt regarding the economic viability of the Development as construction has yet to commence. The market analysis prepared by Appraiser concluded that the proposed golf course would generate sufficient revenues to pay debt service, but at the time it was prepared the Districts had yet to obtain the necessary approval from Town to even begin infrastructure development. From the information provided, it appears that there is still no clear plan for beginning construction.

Further, it is acknowledged that additional financing would be required to proceed with any development as the proceeds from the Bonds merely provided for the acquisition of the real property. Although Authority entered into a number of agreements with the Districts providing for an alternative source of revenues, those agreements were also contingent upon the parties obtaining approval from the local government, a process which apparently has not been started. Accordingly, given the number of contingencies that would have to occur before Authority earned any revenues, there is a valid argument that the parties did not reasonably expect Authority to pay the debt service on the Bonds.

In addition, the facts suggest that the Credit Enhancement Agreement was not merely incidental to the Bonds, but, in substance, a separate debt instrument to which bondholders would look for the payment of debt service. The REMIC Bonds were issued by Corporation 4 ostensibly to provide financing for the construction of the office building in City. The REMIC Bonds are backed by the payments due under the Government Lease. While the Class A REMIC Bond proceeds were apparently loaned to Limited Partnership, the Class B REMIC Bonds were obtained by Corporation 3 and pledged to secure the Credit Enhancement Agreement with Authority. Since it appears unlikely that Authority will have sufficient revenues to pay debt service on the Bonds, the Credit Enhancement Agreement, ultimately secured by the Government Lease, is arguably separate from, rather than incidental to, the Bonds.

Based on the facts provided, there is a strong argument that the parties expected the Credit Enhancement Agreement, rather than Authority, to pay debt service on the Bonds. The Credit Enhancement Agreement, secured by the Class B REMICS, appears to be a separate debt instrument, rather than incidental to the Bonds. Accordingly, the transaction was arguably structured in a manner that is inconsistent with the purposes of section 103. See Rev. Rul 94-42.

2. Federal Guarantee

Section 103(a) of the Internal Revenue Code provides that gross income does not include interest on certain State or local bonds. Section 149(b)(1), however, provides that section 103(a) does not apply to a State or local bond that is federally guaranteed.

Section 149(b)(2) provides that a bond is federally guaranteed, if:

(i) the payment of debt service on the bond is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof;

(ii) 5 percent or more of the proceeds of the issue of which the bond is a part is to be used to make loans, the payment of which is to be guaranteed in whole or in part by the United States or any agency or instrumentality thereof, or is to be directly or indirectly invested in federally insured deposits or accounts; or

(iii) the payment of debt service on the bond is otherwise indirectly guaranteed in whole or in part by the United States or any agency or instrumentality thereof.

The prohibition under section 149 applies not only to direct guarantees, but also in circumstances where an underlying arrangement may result in the federal government indirectly guaranteeing debt service on an obligation. Congress intended that the determination of whether a federal guarantee exists be based on the underlying economic substance of a transaction, taking into account all facts and circumstances. See H.R. Rep. No. 99-426, at 1013 (1985).

The legislative history to section 149 suggests that an indirect federal guarantee may arise where the federal government contracts to purchase the output of a bond-financed facility. Id. Similarly, where the federal government leases property there may be an indirect guarantee by the United States.

In the instant case, no facts have been developed that would evidence a direct guarantee by the federal government. The current question, rather, is whether the payments received under the Government Lease, that ultimately secure the Credit Enhancement Agreement, create an indirect federal guarantee of the Bonds.

As discussed, we concur there is a question as to whether Authority expected to have sufficient revenues to pay debt service on the Bonds. The Indenture specifically states that all payments of principal and interest on the Bonds (except for interest for the period prior to Date 2) shall be made from draws on the credit enhancement. It is beyond dispute that the Credit Enhancement Agreement is secured by the payments under the Government Lease.

Moreover, the offering memorandum for the Bonds provides that it is a condition for issuance of the Bonds that counsel for the United States render an opinion that the obligation to pay rent under the lease constitutes an absolute and unconditional obligation of the government. In the event any payments that are due under the lease are not made, Limited Partnership or the trustee would be entitled to enforce the payment obligations of the United States in accordance with the terms of the lease.

The legislative history to section 149 specifically states that payments under a governmental lease may constitute an indirect guarantee. From the facts provided, it appears that the Bonds are indirectly guaranteed by the federal government. The issuance of the Bonds was apparently conditioned on the parties obtaining an opinion from government counsel that the Government Lease was an unconditional obligation of the federal government. This may be a contractual obligation of the federal government of the type described in the legislative history. Before making a final determination with respect to this matter, we request that you provide us with a copy of the lease in question so that we may examine the terms.

3. 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.

From the facts provided, there is a potential argument that the Bonds overburden the tax-exempt bond market. Since formation of the Districts, approximately $p of bonds have been issued on a tax-exempt basis without any resulting development. Substantial additional financing would be required to even begin the required infrastructure improvements in Development. At the time the Bonds were issued, the permits and zoning changes necessary to begin construction had not been obtained. As a result, there is a valid question as to whether Authority expected to have sufficient revenues to pay debt service on the Bonds. The doubt surrounding the economic viability of the Development raises the question as to whether there was a legitimate governmental purpose behind the issuance of the Bonds and whether more tax-exempt bonds were issued than necessary.

However, an argument that an issuance of bonds constitutes an abusive arbitrage device is highly dependent on the facts and circumstances. To successfully argue that the Bonds overburdened the market, it would be necessary to challenge the validity of the property appraisal and market analysis performed by

Appraiser. Although the facts indicate that the Appraiser's report was, at the very least, overly optimistic, there is insufficient information to prove it was flawed at the time it was prepared. Accordingly, we recommend additional development before asserting this argument.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Based on the available facts, we concur that the transaction in question appears inconsistent with the intent of section 103. The troubled financial history of the Development, the questions concerning the fair market value of the underlying real estate, the relationship between the parties, and the amount of bonds issued all provide evidence that the transaction was structured so that the Credit Enhancement Agreement would pay debt Service on the Bonds rather than Authority. Such evidence would support the argument that the principles stated in Rev. Rul. 94-42 are applicable and interest on the Bonds is not tax-exempt.

Further, there is a strong argument that the payments under the Government Lease create an indirect federal guarantee proscribed by section 149. Evidence supporting this argument includes the offering memorandum providing that the issuance was contingent upon obtaining a legal opinion that the lease arrangement was a valid obligation of the United States and the fact that the Indenture provides that all debt service after Date 2 is paid from by the Credit Enhancement Agreement, which in turn is secured by the lease payments.

[redacted] Arguing that the Bonds violate section 103 because the debt service is expected to be paid by the Credit Enhancement Agreement is not only fact sensitive, but requires reliance on a revenue ruling that has not been tested in any jurisdiction. Similarly, there is virtually no published guidance or judicial authority regarding what constitutes an indirect federal guarantee.

[redacted]

[redacted]

Your memorandum also indicates that purchasers of the Bonds were to exchange the Bonds pursuant to an "Exchange Offer." From the information available, however, we are unable to ascertain the details of this arrangement. To properly address the issues in this case, we believe it is necessary to develop this point. [redacted]

Finally, [redacted] it may be helpful to have our legal position supported by technical advice. We are willing to provide any additional assistance you may require in preparing this case for a request for technical request.

Please call if you have any further questions.

By: Joel E. Helke
JOEL E. HELKE
Branch Chief
Financial Institutions & Products

cc: