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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:TEB/PLR-120069-00
Date:
February 9, 2001

Legend

Issuer =
State =
Counties =
City =
Bonds =
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Dear :

This letter is in response to your request on behalf of the Issuer for a ruling that payments on the swap described below be taken into account in the computation of yield on certain nonpurpose investments of the Issuer for purposes of the yield restriction and arbitrage rebate rules under § 148 of the Internal Revenue Code.

Facts and Representations

The Issuer is a nonprofit housing finance corporation created by the State to act on behalf of the Counties and the City. The Issuer assists in financing housing for low and moderate income persons within the boundaries of the Counties and the City.

In furtherance of its purposes, the Issuer intends to issue the Bonds as qualified mortgage bonds under § 143. The Bonds will be fixed rate bonds with a maturity of approximately a years. The sale proceeds of the Bonds will either be (a) deposited into an acquisition fund or a down payment assistance fund, or (b) applied to refund previously issued bonds which the Issuer represents are qualified mortgage bonds. Any transferred proceeds from the refunded bonds will be deposited into the acquisition fund.

The proceeds on deposit in the acquisition fund will be used to acquire qualified mortgage loans. The proceeds on deposit in the down payment assistance fund will be used to assist in financing down payments and mortgage closing costs.

Until expended for the governmental purposes of the Bonds, the Issuer will invest all of the proceeds on deposit in the acquisition and the down payment assistance funds in shares (the “money market shares”) of a publicly offered regulated

investment company operating as a money market fund (the "money market fund"). The money market fund pays dividends on the money market shares. The rate of dividends paid on the shares (the "money market rate") is variable, based on the yields on the money market instruments purchased by the money market fund.

Concurrently with the purchase of the money market shares, the Issuer intends to enter into an on-market swap agreement (the "swap") with an unrelated third party (the "swap provider") with respect to the money market shares. The Issuer's primary purpose for entering into the swap is to reduce its exposure to fluctuations in the money market rate, and thus, achieve certainty in its investment return.

The term of the swap will be equal to the entire period that proceeds in the acquisition and down payment assistance funds are invested in the money market shares. The Issuer does not reasonably expect that the swap will be terminated before the end of that period.

The notional principal amount of the swap will be based on the amount of proceeds in the acquisition and down payment assistance funds invested in the money market shares. In particular, the notional principal amount for any period between payment dates on the swap will be equal to average daily balance of the money market shares during such period. Under the swap, the Issuer will be obligated to make payments to the swap provider based on a variable rate and the swap provider will be obligated to make payments to the Issuer based on a fixed rate. Payments between the Issuer and the swap provider will be netted. The Issuer expects the variable rate to be substantially the same as the money market rate throughout the term of the swap.

The payment dates under the swap will correspond exactly in time to the payment dates of dividends on the money market shares. The Issuer intends to make the payments under the swap with amounts received as dividends on the money market shares.

Not later than three days after entering into the swap, the Issuer will identify the swap as relating to the money market shares on its books and records for the acquisition and down payment assistance funds. The Issuer will note the existence of the swap by stating, on the Information Return for Tax-Exempt Private Activity Bond Issues (Form 8038) filed with the Internal Revenue Service with respect to the Bonds, that it has identified a swap related to the investment of proceeds of the Bonds.

As more fully described in the ruling request, the Issuer will award the swap to a swap provider on the basis of a competitive bidding process following rules substantially the same as the rules contained in § 1.148-5(d)(6)(iii) of the Income Tax Regulations, modified to take into account the differences between swaps and guaranteed investment contracts or other investments. The winning bidder will be the provider that offers to pay the highest fixed rate in exchange for the variable rate stated in the bid specifications.

The Issuer expects to use a bidding agent to conduct the competitive bidding process. The Issuer will pay the bidding agent a reasonable fee. The Issuer will not consider such fee to be reasonable unless it is comparable to fees charged by bidding agents for a reasonably comparable swap if it were used to hedge the investment of funds other than gross proceeds of tax-exempt bonds.

Law

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that subsection (a) shall not apply to any arbitrage bond (within the meaning of § 148).

Section 148(a) provides that the term "arbitrage bond" means 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, for purposes of § 148(a), 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 (1) or (2).

Higher yielding investments means any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue. § 148(b)(1). Investment property includes any security, obligation, annuity contract, or investment-type property. § 148(b)(2).

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. § 148(c). However, § 148(f)(1) provides that a bond which is part of an issue shall be treated as an arbitrage bond if the issuer fails to pay to the United States the amount of any earnings on nonpurpose investments that exceed the amount that would have been earned if the nonpurpose investments were invested at a rate equal to the yield on the issue. As of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments. § 1.148-3(b). Nonpurpose investment means any investment property, as defined in § 148(b), that is not an investment that is acquired to carry out the governmental purpose of an issue. § 1.148-1(b).

Section 1.148-4 provides rules for computing the yield on an issue of bonds. Section 1.148-4(h)(1) requires that payments made or received by an issuer under a qualified hedge relating to bonds of an issue be taken into account to determine the yield on the issue. Section 1.148-4(h)(2) generally defines qualified hedge as a contract that satisfies the following requirements:

(i)(A) The contract is entered into primarily to modify the issuer's risk of interest changes with respect to a bond (a hedge).

(B) If the contract modifies the issuer's risk of interest rate changes with respect to a bond that is part of an issue that, absent the contract, would be a fixed rate issue, the contract must be entered into --

(1) No later than 15 days after the issue date (or the deemed issue date under § 1.148-4(d)) of the issue; or

(2) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies § 1.148-4(h)(2)(i)(B)(1); or

(3) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies either § 1.148-4(h)(2)(i)(B)(2) or § 1.148-4(h)(2)(i)(B)(3).

(C) If a hedge provider makes a single payment to the issuer (e.g., a payment for an off-market swap) in connection with the acquisition of a contract, the issuer may treat a portion of that contract as a hedge provided—

(1) The hedge provider's payment to the issuer and the issuer's payments under the contract in excess of those that it would make if the contract bore rates equal to the on-market rates for the contract (determined as of the date the parties enter into the contract) are separately identified in a certification of the hedge provider; and

(2) The payments described in § 1.148-4(h)(2)(i)(C)(1) are not treated as payments on the hedge.

(ii) The contract does not contain a significant investment element.

(iii) The contract is entered into between the issuer or the political subdivision on behalf of which the issuer issues the bonds and a provider that is not a related party.

(iv) The contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (i.e., all of the bonds having the same interest rate, maturity, and terms).

(v) The contract is primarily interest based.

(vi) The payments received by the issuer from the hedge provider under the contract correspond closely in time to either the specific payments being hedged on the hedged bonds or specific payments required to be made pursuant to the bond documents, regardless of the hedge, to a sinking fund, debt service fund, or similar fund maintained for the issue of which the hedged bond is a part.

(vii) Payments to the hedge provider are reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal and interest on the hedged bonds.

(viii) The contract must be identified by the actual issuer on its books and records maintained for the hedged bonds not later than 3 days after the date on which the issuer and the hedge provider enter into the contract, and the existence of the hedge must be noted on the first form relating to the issue of which the hedged bonds are a part that is filed with the Internal Revenue Service on or after the date on which the contract is identified.

Section 1.148-4(h)(3) provides accounting rules for qualified hedges. For example, that section provides that payments made or received by the issuer under a qualified hedge are treated as payments made or received, as appropriate, on the hedged bonds that are taken into account in determining the yield on those bonds.

Section 1.148-4(h)(4)(i) provides that if the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if:

(A) The term of the hedge is equal to the entire period during which the hedged bonds bear interest at variable interest rates, and the issuer does not reasonably expect that the hedge will be terminated before the end of that period.

(B) Payments to be received under the hedge correspond closely in time to the hedged portion of payments on the hedged bonds.

(C) Taking into account all payments made and received under the hedge and all payments on the hedged bonds (i.e., after netting all payments), the issuer's aggregate payments are fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. Payments on bonds are treated as fixed for purposes of § 1.148-4(h)(4)(i)(C) if payments on the bonds are based, in whole or in part, on one interest rate, payments on the hedge are based, in whole or in part, on a second interest rate that is substantially the same as, but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index may be substantially the same as an issuer's individual 30-day interest rate.

Section 1.148-4(h)(4)(ii) provides additional accounting rules for circumstances in which hedged bonds that would otherwise be variable yield bonds are treated as fixed yield bonds paying a fixed interest rate.

Section 1.148-5 provides rules for computing the yield and value of investments allocated to an issue. § 1.148-5(a). The yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. § 1.148-5(b)(1).

Section 1.148-5(d)(6)(i) provides that the fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction. Fair market value generally is determined on the date on which a contract to purchase or sell the nonpurpose investment becomes binding (i.e., the trade date rather than the settlement date). Except as otherwise provided in § 1.148-5(d)(6), an investment that is not of a type traded on an established securities market, within the meaning of § 1273, is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value.

Section 1.148-5(d)(6)(iii) provides a safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow. In particular, this safe harbor provides for a competitive bidding process to establish fair market value.

Section 1.148-5(e)(2)(i) provides, in general, that in determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. General overhead costs and similar indirect costs of the issuer such as employee salaries and office expenses and costs associated with computing the rebate amount under § 148(f) are not qualified administrative costs. In general, administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

Analysis

The regulations do not provide specific rules for the treatment of hedges of nonpurpose investments. *See* the explanation of provisions preceding the final regulations published May 9, 1997, 62 FR 25504, 1997-1 C.B. 49. At the same time, however, the regulations do not preclude the integration of hedges with nonpurpose investments in appropriate circumstances.

Under the facts and circumstances of this case, we conclude that it is appropriate to take the payments made or received by the Issuer under the swap into account in the computation of yield on the money market shares for purposes of the yield restriction and arbitrage rebate rules under § 148. In structuring the transaction,

the Issuer determined that it wants to receive a fixed rate of return from its investment of the proceeds of the Bonds. The combination of investing the proceeds in the money market shares and entering into the swap is the mechanism chosen by the Issuer to achieve the fixed rate of return. Given this intent, the Issuer would not invest in the money market shares without entering into the swap. Taking the payments made or received by the Issuer under the swap into account in computing yield on the money market shares simply reflects the economic substance of the transaction.

Because there are no specific rules relating to the treatment of hedges of nonpurpose investments, we apply, by analogy, the rules relating to qualified hedges of bonds in § 1.148-4(h) to determine whether the payments made or received by the Issuer under the swap should be taken into account in computing the yield on the money market shares. The application of the requirements of a qualified hedge set forth in § 1.148-4(h)(2) indicates that this is an appropriate case for integration. In addition, the application of the requirements of § 1.148-4(h)(4)(i) indicates that this is an appropriate case in which to treat the integrated money market shares and swap as a fixed yield investment. In coming to these conclusions, we emphasize that the identification of the swap on the Issuer's books and records and the Form 8038 for the Bonds is evidence of the Issuer's intent and desire to take the swap into account for purposes of applying the yield restriction and arbitrage rebate rules under § 148.

As a result of the integration of the swap and the money market shares, the payments made or received by the Issuer under the swap must be accounted for using rules similar to those described in §§ 1.148-4(h)(3) and 1.148-4(h)(4)(ii), taking into account the differences between hedges of bonds and nonpurpose investments. For example, the payments made by the Issuer under the swap will be treated as payments for the money market shares and payments received by the Issuer under the swap will be treated as receipts on the money market shares.

The swap is not traded on an established securities market. Notwithstanding, the Issuer's use of bidding procedures substantially the same as those in § 1.148-5(d)(6)(iii) to choose the swap provider is sufficient evidence that the payments under the swap reflect fair market value.

Finally, the Issuer may take into account the bidding agent's fee as a qualified administrative cost under § 1.148-5(e)(2), to the extent such fee is reasonable. In light of the integration of the payments and receipts on the swap with the payments and receipts on the money market shares for purposes of computing yield, the bidding agent's fee should be treated as a cost of purchasing the integrated investment and should be taken into account accordingly.

Conclusion

We conclude that it is appropriate to take the payments on the swap into account in the computation of yield on the money market shares for purposes of the yield restriction and arbitrage rebate rules under § 148.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether interest on the Bonds is excludable from gross income under § 103(a).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/Government Entities)
By: Bruce M. Serchuk
Senior Technician Reviewer
Tax Exempt Bond Branch

cc: