INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

January 17, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200622047**
Release Date: 6/2/2006
Index (UIL) No.: 143.00-00
CASE-MIS No.: TAM-137469-05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Issuer =

State=

City=

Bonds=

Taxable Bonds=

Refunding Bonds=

Date 1=

Date 2 =

Date 3=

Date 4=

X=

ISSUES:

1. Whether unspent proceeds of the Bonds are excess proceeds subject to the special allocation rule in § 1.148-4T(e)(1) of the 1989 temporary Income Tax Regulations.

2. Whether unspent proceeds of the Bonds are transferred proceeds within the meaning of §§ 1.148-8T(d)(8) and 1.148-4T(e)(2)(i) of the 1989 temporary Income Tax Regulations.

3. Whether the Refunding Bonds meet the transition rule of § 1313(a) of the Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085 (1986)(the "TRA"). In particular,

a. Whether the Refunding Bonds meet the introductory language of § 1313(a)(1);

b. Whether property financed with the proceeds of the Refunding Bonds are "facilities" as that term is used in § 1313(a)(1)(B)(i);

c. Whether the Issuer erred in computing the average maturity of the Refunding Bonds and the average reasonably expected economic life of the financed property under § 1313(a)(1)(B)(i) when it used weighted averages in making those computations; and

d. Whether, in determining the economic life of the mortgages under § 1313(a)(1)(B)(i), the Issuer erred by failing to take into account anticipated mortgage prepayments and losses .

CONCLUSIONS:

1. The unspent proceeds of the Bonds are not excess proceeds within the meaning of § 1.148-4T(e)(1)(iv) of the 1989 temporary Income Tax Regulations.

2. The unspent proceeds of the Bonds became transferred proceeds of the Refunding Bonds under §1.148-4T(e)(2)(i) of the 1989 temporary Income Tax Regulations when proceeds of the Refunding Bonds redeemed the Bonds.

3a. The Refunding Bonds meet the introductory language of § 1313(a)(1) of the TRA to the extent that the proceeds of those bonds were used to refund the Bonds.

3b. The property financed with the sale proceeds of the Refunding Bonds are facilities within the meaning of § 1313(a)(1)(B)(i) of the TRA.

3c. The Issuer did not err in computing the average maturity on the Refunding Bonds and the average reasonably expected economic life of the financed property when it used a weighted average in making those computations.

3d. Because we conclude that the property financed with the proceeds are the residences and not the Mortgages, we do not address whether the economic life of the Mortgages was properly computed when the Issuer failed to take into account expected prepayments and losses on those Mortgages.

FACTS:

Three bond issues are relevant to this case, the Bonds, the Taxable Bonds, and the Refunding Bonds.

The Bonds were issued on Date 1, to purchase from lending institutions mortgage loans made to persons of low and moderate income for residential housing facilities located within the City (the "Mortgages"). Because Date 1 is before August 16, 1986, the Bonds are subject to the Internal Revenue Code of 1954 (the "1954 Code"). In addition, while the Bonds were issued after April 24, 1979, the effective date of the Mortgage Subsidy Bond Tax Act (the "MSBTA"), 1980-2 C.B. 509, 512, the Bonds met the transition rules of § 1104(a)(2) and § 1104(d)(5) of the MSBTA, and thus are subject to § 103 and not § 103A of the 1954 Code. There is no dispute that interest on the Bonds was excludable from gross income under § 103 of the 1954 Code.

The Taxable Bonds were issued after August 15, 1986, on Date 2. The Taxable Bonds were payable from the Mortgages after the final payment of the Bonds. Issuer represents that the Taxable Bonds could have been issued as tax-exempt bonds under the 1954 Code or the Internal Revenue Code of 1986 (the "1986 Code"). Issuer further represents that the Taxable Bonds could have been advance refunded under the 1986 Code with tax-exempt bonds.

The Refunding Bonds were issued on Date 3, a date that is after August 15, 1986. On the issue date of the Refunding Bonds, the amount of those bonds did not exceed the outstanding amount of the Bonds. Sale proceeds of the Refunding Bonds were 1) invested at a yield that was less than the yield on the Refunding Bonds until those proceeds were used to refund the Bonds, which occurred within 90 days after issuance of the Refunding Bonds, 2) used to pay interest on the Refunding Bonds, and 3) used to create a reserve fund for the Refunding Bonds. The final maturity date of the

Refunding Bonds is Date 4, which is more than 17 years from the date of issue of the Bonds.

Issuer asserts that the weighted average maturity of the Refunding Bonds is less than 120% of the weighted average reasonably expected economic life of the Mortgages. Issuer determined the economic life of the Mortgages without taking into account expected prepayments and losses on the Mortgages. We have not been provided with information on the average reasonably expected economic life of the residences financed with the Mortgages.

When the Bonds were redeemed with proceeds of the Refunding Bonds, there were unspent proceeds of the Bonds of approximately X. Issuer invested most of the unspent proceeds in United States Treasury Obligations that were deposited to an escrow fund to be used to redeem the Taxable Bonds at their earliest redemption date, a date that was more than 90 days after the date of issue of the Refunding Bonds. The remaining unspent proceeds were invested by the City, on behalf of the Issuer, with other investments held by the City. Issuer represents that the invested proceeds were used in a manner that could have been financed with tax-exempt bonds under either the 1954 or 1986 Code. Since the refunding, unspent proceeds of the Bonds have been invested at a yield that does not exceed the yield on the Refunding Bonds.

LAW AND ANALYSIS:

1. Are the unspent proceeds of the Bonds excess proceeds?

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any State or local bond.[1] Section 103(b)(2) provides an exception for any arbitrage bond within the meaning of § 148. Section 148 defines the term "arbitrage bond" to include any bond issued as part of an issue any portion of the proceeds of which are reasonably expected to be used directly or indirectly to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments.

The current regulations under § 148 generally apply to bonds sold after July 7, 1997, a date that is after Date 3. In certain cases, however, an issuer may apply the current regulations to certain issues outstanding on July 8, 1997. Issuer has not applied those regulations; instead it has applied the 1989 temporary Income Tax Regulations issued under § 148, T.D. 8252, 1989-1 CB 25 (the “1989 temporary regulations”). Of relevance to this issue is § 1.148-4T of the 1989 temporary regulations, which provides allocation and accounting rules, including a special rule for refunding bonds under which certain mandatory allocations are required for excess proceeds.

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[1] Unless otherwise stated, all references to Code sections are to the 1986 Code.

Section 1.148-4T(e)(1)(i) of the 1989 temporary regulations provides that excess proceeds of a refunded issue shall be allocated to investments the receipts from which are to be used to discharge the principal or interest on or the retirement price of bonds that are part of the refunded issue. Excess proceeds of a refunded issue shall be allocated to these investments in such manner as to ensure that the expenditure of such funds and proceeds does not occur later than the expenditure of any sale proceeds of the refunding issue that are allocated to such investments. § 1.148-4T(e)(1)(ii). The agent questions whether this special allocation rule applies to the unspent proceeds of the Bonds.

Section 1.148-4T(e)(1)(iv) of the 1989 temporary regulations provides that the term "excess proceeds" means, with respect to a refunded issue, amounts that at the time of issuance of the refunding issue are proceeds of the refunded issue if -- (A) the amounts are allocated to investments described in § 1.148-4T(e)(1)(i) and are described in paragraph (e)(1)(iii)(C) or (e)(1)(iii)(D) of the section or (B) the amounts were to be used to pay interest on the refunded portion of the refunded issue that accrues within the period of time described in § 1.103-15(b)(2) and are described in paragraph § 1.148-4T(e)(1)(iii)(C).

While the relationship between the definition of excess proceeds and the special allocation rule is not clear in the regulations, we determine that there first must be proceeds of the refunded bonds used in a manner described in § 1.148-4T(e)(1)(iv) before the special allocation rule in § 1.148-4T(e)(1) can apply to those proceeds.

Here, the unspent proceeds of the Bonds do not meet the definition of excess proceeds because those proceeds were not used to pay interest on the Bonds or invested in investments the receipts from which were to be used to discharge principal or interest on or the retirement price of bonds that are part of the refunded issue. Thus, the special allocation rule of § 1.148-4T(e)(i) of the 1989 temporary regulations does not apply to the unspent proceeds.

2. Did the unspent proceeds of the Bonds become transferred proceeds of the Refunding Bonds?

Section 1.148-8T(d)(8) of the 1989 temporary regulations provides that the term "transferred proceeds" means, with respect to a refunding issue, proceeds that have ceased to be proceeds of a refunded issue and are transferred proceeds of the refunding issue by reason of § 1.148-4T(e)(2)(including amounts actually or constructively received from investing such proceeds).

Section 1.148-4T(e)(2)(i) of the 1989 temporary regulations states that at the close of business on the date that any amount of the proceeds of a refunding issue are used to discharge the principal or interest on or the retirement price of any bond that is part of refunded issue, the same amount of the proceeds of the refunded issue shall

cease to be treated as proceeds of the refunded issue and shall be treated as transferred proceeds of the refunding issue.

Proceeds of the Refunding Bonds were used to redeem the Bonds. At that time, unspent proceeds of the Bonds became “transferred proceeds” of the Refunding Bonds under § 1.148-4T(e) of the 1989 temporary regulations. We note, however, that the facts state the transferred proceeds were invested at a yield that was less than the yield on the Refunding Bonds.

3. Section 1313 of the TRA

Section 1301 of the TRA reorganized and modified § 103 and § 103A of the 1954 Code. The modifications included the addition of § 143, which sets forth rules for residential mortgage bonds. The agent questions whether § 143 applies to the Refunding Bonds.

Generally the changes made by the TRA apply to bonds issued after August 15, 1986. § 1311(a) TRA. However, the TRA included transition rules. Of relevance here is § 1313(a), which contains transition rules for current refundings. In particular, § 1313(a)(1) provides that except as provided in § 1313(a)(3), the amendments made by §1301 shall not apply to any bond the proceeds of which are used exclusively to currently refund a qualified bond if,

> (A) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and
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> (B)(i) the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the net … proceeds of such issue (determined under § 147(b) of the 1986 Code) [the “120% transition rule”], or
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> (ii) the refunding bond has a maturity date not later than the date which is 17 years after the date on which the qualified bond was issued [the “17 year transition rule”].
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> In the case of a qualified bond which was (when issued) a qualified mortgage bond or a qualified veterans’ mortgage bond, subparagraph (B)(i) shall not apply and subparagraph (B)(ii) shall be applied by substituting “32 years” for “17 years” [the “32 year transition rule”].

Section 1313(a)(2) provides, in part, that the term “qualified bond” means any bond (other than a refunding bond) issued before August 16, 1986. Qualified mortgage bonds are certain bonds described in § 103A of the 1954 Code.

The Refunding Bonds were issued after the effective date of the 1986 Code, and are subject to that Code unless § 1313(a) applies to the Refunding Bonds. The Refunding Bonds do not meet the 17 year transition rule. In addition, the 32 year transition rule does not apply to the Refunding Bonds because the Bonds are not qualified mortgage bonds under § 103A of the Code. Thus, the Refunding Bonds must meet the 120% transition rule for § 143 not to apply. In questioning whether the Refunding Bonds meet the requirements of §1313(a) and the 120% transition rule, the request for technical advice asks,

1. Whether the Refunding Bonds meet the introductory language of § 1313(a)(1);

2. Whether property financed with the proceeds of the Refunding Bonds are "facilities" as that term is used in § 1313(a)(1)(B)(i);

3. Whether the Issuer erred in computing the average maturity of the Refunding Bonds and the average reasonably expected economic life of the financed property under § 1313(a)(1)(B)(i) when it used weighted averages in making those computations; and

4. Whether in determining the economic life of the mortgages under § 1313(a)(1)(B)(i), the Issuer erred by failing to take into account anticipated mortgage prepayments and losses.

a. Whether the Refunding Bonds meet the introductory language of § 1313(a)(1)

Section 1313(a) provides that proceeds of the refunding bond must have been used exclusively to currently refund a qualified bond. The Bonds were issued before August 16, 1986, and thus, met the definition of a qualified bond. The sale proceeds of the Refunding Bonds were used to currently refund the Bonds (and to pay interest on the Refunding Bonds and create a reserve fund for the Refunding Bonds). As discussed above, however, at the time of the refunding, unspent proceeds of the Bonds transferred to the Refunding Bonds. These proceeds were not used for costs associated with refunding of qualified Bonds. Instead, some of those proceeds were used to advance refund the Taxable Bonds that were issued after August 15, 1986,[2] and some were invested, the receipts from which funded new money costs.

The term "proceeds" is not defined in § 1313 or in the applicable definition section, § 1318. Moreover, the term proceeds has not been consistently defined. For example, for arbitrage purposes proceeds generally includes transferred proceeds. See, e.g., § 1.148-1(b) of the current regulations and § 1.148-8T(d)(2) of the 1989

[2] While there is a transition rule in the TRA for advance refunding bonds, that rule is limited to advance refundings of bonds other than industrial development bonds issued before August 15, 1986. This rule does not apply to any bond of the Refunding Bonds. See § 1313(b) of the TRA.

temporary regulations. For the private business tests, proceeds does not include transferred proceeds. § 1.141-1(c). Thus, it is not clear whether the term "proceeds" in § 1313(a) includes transferred proceeds. However, even if proceeds includes transferred proceeds, § 1313(a) could still apply to part of the Refunding Bonds.

Section 1313(a) states that § 1301 does not apply to "any bond the proceeds of which are used exclusively to currently refund a qualified bond." We contrast this language with the language in § 1313(a)(1)(B)(i) which considers "the issue of which the refunding bond is a part." In the first case, the statute considers the use of proceeds of a particular bond in an issue; in the second, the statute considers the entire issue. Thus, we conclude that a refunding bond may be transitioned under § 1313(a) even if all of the proceeds of the issue are not used exclusively to refund a qualified bond. This leaves the question of which law applies to the portion of the refunding issue that was not used to refund a qualified bond. We do not need to address this question unless you determine the Issuer's representation that the transferred proceeds were used in a manner that complies with either the 1986 or 1954 Code is incorrect.

Issuer argues that the transitional treatment for current refundings provided in § 1313(a) of the TRA is actually "unnecessary" for the Refunding Bonds as the Bonds were not subject to § 103A of the 1954 Code. As support for its conclusion Issuer points to 1) the fact that the Bonds met the transition rules of § 1104(a)(2) and § 1104(d)(5) of the MSBTA and thus were subject to § 103 of the 1954 Code and 2) the Conference Report for the TRA, which states,

> Like the House Bill, the conference agreement reorganizes and amends the present-law rules governing tax-exemption for interest on obligations issued by or on behalf of qualified governmental units. As part of this reorganization, the present-law rules contained in Code sections 103 and 103A are divided, by topic, into 11 Code sections (secs. 103 and 141-150). The conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions.
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> [footnote 3 to the above statement provides] As under present law, interest on certain bonds authorized under non-Code provisions of law is tax-exempt under Code section 103 if the authorizing legislation was enacted before January 1, 1984, and the bonds comply with all appropriate Code requirements. H.R. Conf. Rep. No. 99-841, 99th Cong. 2d Sess. (Sept. 18, 1986) at II-686.

We disagree with the Issuer's reasoning. While the facts indicate that the Bonds were transitioned under the MSBTA, the legislative history cited by Issuer does not support Issuer's conclusion because the transition rules of MSBTA do not authorize bonds; they merely inform which law applies to bonds.

b. Whether property financed with the proceeds of the Refunding Bonds are "facilities" as that term is used in § 1313(a)(1)(B)(i).

In considering whether the proceeds of the Refunding Bonds acquired "facilities" within the meaning of the 120% transition rule, we consider 1) whether the property financed with the net proceeds of the refunding issue are the Mortgages or the residences that are acquired with the Mortgages,[3] and 2) whether such property (i.e., the Mortgages or residences, whichever is appropriate) are facilities.

The 120% transition rule requires the test to be determined under § 147(b) of the 1986 Code. Section 147(b)(1) provides that,

> Except as provided in subsection (h), a private activity bond shall not be a qualified bond if it is issued as part of an issue and--
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> (A) the average maturity of the bonds issued as part of such issue, exceeds
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> (B) 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of the issue.

Section 147(b)(2) provides that for purposes of § 147(b)(1),

> (A) the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of such issue, and
>
> (B) the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

Section 147(h) provides, in part, that subsection (b) of section 147 shall not apply to any qualified mortgage bond, qualified veterans' mortgage bond, or qualified student loan bond.

Applying § 147(b) in this case is not straightforward because under § 147(h), paragraph (b) does not apply to qualified mortgage bonds. Thus, the provision does not contemplate computing economic life when bonds finance mortgages similar to those at issue in this case. However, paragraph (b) applies in analogous situations, such as when an issuer uses the proceeds to finance a loan to a conduit borrower. To determine whether paragraph (b) is satisfied in those cases, the asset that is financed is not the loan to the conduit borrower, but the property that the loan finances. Applying that analysis to the instant case leads us to conclude that the financed property is the residences financed with the Mortgages and not the Mortgages.

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[3] While proceeds of the Refunding Bonds were used to pay principal and interest on the Bonds, the test makes sense only if we consider what the Bonds financed.

We further conclude that the residences are “facilities” for the 120% transition rule. “Facility” is not defined in §1313(a) or the legislative history to the TRA. The legislative history to the TRA can be read, however, to support a liberal reading of the term that would include any property financed with the net proceeds. The Conference Report states that “the average maturity of the refunding issue (1) does not exceed 120 percent of the reasonably expected economic life of the *property* identified as being financed with the refunded bonds…” H.R. Conf. Rep. No. 99-841 at II-695 (1986) (emphasis added).

Because we conclude that the financed facilities are the residences, we do not address whether the economic life of the Mortgages was properly computed when the Issuer did not take into account expected prepayments and losses.

c. Whether the Issuer erred in computing the average maturity of the Refunding Bonds and the average reasonably expected economic life of the facilities under § 1313(a)(1)(B)(i) when it used weighted averages in making those computations[4]

Finally, we address whether the average reasonably expected economic life of the financed facilities and the average maturity of the Refunding Bonds is be computed using a weighted average for the 120% transition rule. Again, we look to § 147(b). There are no regulations or other published guidance on what is meant be “average maturity” and “average reasonably expected economic life”. However, § 147(b)(2) states that the average maturity of an issue shall be determined by taking into account the respective issue prices of the bonds issued as part of such issue and the average reasonably expected economic life of the financed facilities shall be determined by taking into account the “respective cost of such facilities.” This provision implies that the averages under § 147(b) are weighted averages. Moreover, the legislative history of § 147(b) indicates that it is reasonable to conclude that both the average maturity on the bonds and the average reasonably expected economic life of financed facilities is determined using a weighted average.

The legislative history to § 147 indicates that the economic life test in § 147(b) of the 1986 Code was not changed from that same test in prior law except to expand the types of bonds to which § 147(b) applies. H.R. Conf. Rep. No. 99-841 at II-730 (1986) (prior law continues to apply except to the extent modified by the TRA). The economic test under prior law was found in § 103(b)(14) of the 1954 Code, which was added by the Tax Equity and Fiscal Responsibility Act of 1982 (the “1982 Act”), section 219(a), 1982-2 C.B. 462, 496. The Conference Report for the 1982 Act in describing that section provides that “[t]he conference agreement provides a rule that limits the average length of the maturity of all industrial development bonds (IDBs). Under the rule, the

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[4] While the question was asked in the context of the Mortgages, it is likely that the same question will arise when the reasonably expected economic life of the residences financed by the Mortgages is considered.

weighted average maturity of all obligations of an issue cannot exceed the *weighted* average estimated economic life of the assets financed with the proceeds of the issue by more than 20 percent." H.R. Conf. Rep. 97-760, 97th Cong. 2d Sess. at 519 (1982) (emphasis added). We conclude that the Issuer was correct in computing the weighted average maturity of the Refunding Bonds and in determining the weighted average maturity of the facilities.

CAVEAT(S): A COPY OF THIS TECHNICAL ADVICE MEMORANDUM IS TO BE GIVEN TO THE TAXPAYER(S). SECTION 6110(K)(3) OF THE CODE PROVIDES THAT IT MAY NOT BE USED OR CITED AS PRECEDENT.