N. TAX-EXEMPT BONDS CURRENT TOPICS

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Announcement 93-92, 1993-24 IRB 66, announced the consolidation and coordination of all enforcement activities relating to tax-exempt bonds under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations). During the past year much work has been done to foster the orderly creation of a vigorous enforcement program. On January 10, 1994, the Tax-Exempt Bond Action Plan was shared with the public. The release also contained a brief technical discussion of the areas the enforcement program intends to concentrate on in the coming year.

The release states:

> **For FY 1994, among the issues on which the examination program will focus are open market purchases of Treasury obligations for advance refunding escrows and purchases of long-term guaranteed investment contracts. Some issuers may have paid more than fair market value for investments purchased with tax-exempt bond proceeds. Another area of concern is tax-exempt bonds that back-load payments of debt service. While tax-exempt bonds may be issued with these structures for bona fide governmental proposes, this type of debt service structure has a particular potential for arbitrage and other types of non-compliance.**

These targeted enforcement initiatives were discussed at the arbitrage and rebate classes that were attended this year by the agents conducting tax exempt bond examinations. Cases to examine have been distributed to all seven Key Districts. A number of cases were selected by the National Office for the probability that problems in the targeted enforcement areas would be apparent upon examination.

For this year's CPE article we felt that additional guidance in the targeted areas would be helpful. Four of the five subchapters focus on the targeted areas. The fifth subchapter will be valuable to agents as they work cases involving bond

issues. It is an early draft of a portion of the audit guidelines. Proposed audit guidelines are being worked on and will be made available to the public for comment. We believe that an early draft of a portion of the guidelines should be shared to assist Service specialists in beginning the examination of tax-exempt bonds.

1. THE FEDERAL TAX EXPENDITURE AND TAX BENEFIT OF A TAX-EXEMPT BOND ISSUE

How much does the governmental issuer of tax-exempt bonds benefit from tax-exempt interest rates? How much does this benefit cost the federal government? A brief consideration of these questions in an example helps to shed light on what is at stake in tax-exempt financing, and will make two of the targeted enforcement initiatives easier to understand.

1. Example

Suppose the City of Smithville needs to raise $10 million to construct a new city hall. The city determines to issue $10 million of general obligation bonds with a 20-year maturity for the project. All the principal will be paid in 20 years, and that interest will be paid semiannually. If the city can issue the bonds on a tax-exempt basis, the interest rate on the bonds will be 6 percent; if the city had to issue the bonds on a taxable basis, the interest rate would be 8 percent. In this case the city will benefit $200,000 each year that the bonds are outstanding (the city saves 2 percent of $10 million in interest cost each year). The present value of this benefit at the taxable discount rate of 8 percent is about $2 million. That is, on these facts, the city receives a subsidy of about 20 percent of the cost of the project.

2. Cost of the Subsidy

How much does this subsidy cost the federal government? If the city had to issue taxable bonds, the holders would be subject to tax on interest income of $800,000 each year the bonds were outstanding. Assume that all of these holders paid tax at a marginal rate of 30 percent. In this case lost tax revenues would be $240,000 each year. The present value of this cost at a taxable discount rate of 8 percent is about $2.4 million.

What is the tax exposure to the federal government if the bonds are found to be taxable because the issuer fails to comply with the tax-exempt bond rules in the Code? In this case the bonds were actually issued with a 6 percent interest rate, so that the total interest income subject to tax would be $600,000 each year. Assuming that all of the holders paid tax at a marginal rate of 30 percent, the tax exposure would be $180,000 each year. The present value of this tax exposure at a taxable discount rate of 6 percent is about $1.8 million.

Clearly there are a number of different ways to look at the benefits and costs of tax-exempt bond issues. One important point to keep in mind is that, however benefits and costs are looked at, they always depend on how long the tax-exempt bonds are outstanding. This is a theme that arises in many contexts in the tax-exempt bond rules, particularly in the arbitrage area. In addition, this principle is important to keep in mind in discussions of closing agreement standards.

3. Changes in the Payment of Debt Service

Unlike the example above where all the principal was paid at maturity and only interest was paid semi-annually, most tax-exempt bonds are issued with level debt service. This means that a certain portion of the principal is amortized, or paid off each year, much like a typical home mortgage. If the City of Smithville decided to issue its bonds with level debt service, its payments would be about $870,000 each year. In the first year interest would be about $600,000 and in the last year interest would be about $50,000. In this case the total amount of tax-exempt interest will be less, because principal is paid off over time. Just like a home mortgage, interest payments will be high in early years and lower in later years. In this case, the present value benefit to the city from the tax-exempt bonds would be about $1.4 million (rather than $2 million); the federal tax expenditure would be about $1.8 million (rather than $2.4 million); and the federal tax exposure would be about $1.3 million (rather than $1.8 million).

4. Conclusion

This simple example highlights another very important point: the benefits and costs of tax-exempt financing depend on how principal and interest are paid. Bond issues that defer payment of debt service (that "backload" debt service) can greatly increase both the benefits and costs of issuing tax-exempt bonds. This point is addressed by the tax-exempt bond rules in a number of ways and is discussed in the next chapter.

2. INTRODUCTION TO TARGETED ENFORCEMENT INITIATIVES

Bond Issues with Backloaded Debt Service Payments

1. Background

As discussed in the previous subchapter, most tax-exempt bond issues have roughly "level" debt service. This means that payments of principal and interest are approximately the same from year to year. This is much like a home mortgage, where mortgage payments are generally the same from month to month. A home mortgage with all principal and interest payments due at the end of 30 years would be highly unusual. Bond issues that have higher debt service payments in later years are called "backloaded."

Tax-exempt bond issues with backloaded debt service are not uncommon. In many cases there are bona fide governmental purposes for these debt service structures. They are not inherently abusive. Backloaded debt service, however, may be an indicator of possible arbitrage or other abuse. This is in part because deferring payments of debt service is a way to maximize the benefit of borrowing on a tax-exempt basis.

When faced with an issue with backloaded debt service, it is important to understand why the issuer chose that financing structure. For example, many issuers take into account the debt service on all related bond issues in choosing how to structure the debt service on a new bond issue. An issuer may attain overall debt service that is level by adding to existing related issues an issue that has backloaded debt service.

Issues with backloaded debt service have long been a concern of the arbitrage regulations. The concept of the "invested sinking fund" addressed in 1.103-13(g) of the former regulations and in the definition of "replacement" in 1.148-1(c) of the final regulations primarily applies to bond issues with backloaded debt service. In addition, the examples of abusive arbitrage devices in 1.148-10(d) focus on debt service "windows."

Other types of potential abuses may involve bond issues with backloaded debt service, such as zero coupon bonds. Zero coupon bonds pay no interest or principal until maturity. The remainder of this section discusses a type of transaction involving an issue of high yield zero coupon bonds and an

arrangement that is labeled as bond insurance.

2. "Phoney Bond Insurance" Fact Pattern

On June 17, 1994, the Service released Rev. Rul. 94-42, which deals with a noncomplying issue with dramatically backloaded debt service. (This revenue ruling appears in I.R.B. 1994-27, dated July 5, 1994.) County C issued zero coupon bonds having a 30-year term and a stated redemption price at maturity of $204x. M purchased the bonds at original issuance for a price of $4x, resulting in an annual yield on the bonds of approximately 14.0 percent. The bonds are payable solely from revenues of a facility acquired with the bond proceeds and there is significant risk that these revenues will be insufficient to pay all debt service.

One year later, in an unrelated transaction, M entered into an agreement with G, an unrelated third party, under which, in exchange for a payment of $14x from M, G "insured" the payment of all scheduled debt service on the bonds to M or any subsequent holder. In connection with its agreement with M, G purchased $14x of United States Treasury securities yielding approximately 9.6 percent, which G transferred to a trust to secure its obligations under the agreement. The principal and interest on these securities will be sufficient to provide for timely payment of substantially all of the debt service on the bonds.

The G agreement enabled 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 percent. Interest rates on 30-year obligations did not materially change during the one-year period between the issue date of the bonds and the date on which M sold the G agreement and the bonds to the general public.

3. Technical Analysis of Phoney Bond Insurance

The revenue ruling concludes that this transaction is not supported by prior revenue rulings extending favorable treatment to bond insurance arrangements. Rev. Rul. 72-134, 1972-1 C.B. 29, concerns bond insurance purchased by a political subdivision against default in the payment of principal and interest on bonds of the political subdivision. The ruling holds that the insurance does not affect the exclusion from gross income of interest on those bonds under section 103(a) of the Code and that defaulted interest paid by the insurance company is excludable from the gross income of the bondholders under section 103(a) as a

substitute for tax-exempt interest. Rev. Rul. 72-575, 1972-2 C.B. 74, and Rev. Rul. 76-78, 1976-1 C.B. 25, extend the holding of Rev. Rul. 72-134 to bond insurance that is acquired by an underwriter for the bonds or by a bondholder. The three revenue rulings "integrate" the insurance obligation with the underlying bond so that payments made by the insurance company to the bondholder are treated as tax-exempt interest within the meaning of section 103 even though the payments are not made by a governmental unit.

In this situation, the purchasers of the "insured" bonds acquired two obligations from M: the obligation of C on the bonds and the obligation of G under the agreement. The question presented is whether, under Rev. Rul. 76-78, the G obligation will be integrated with the C obligation on the bond so that amounts paid or accrued on the G agreement are excludable from the gross income of the bondholders as a substitute for tax-exempt interest.

The revenue ruling concludes that the scope of Rev. Rul. 76-78 does not extend to this situation. In that prior revenue ruling, the insurance contract is not a separate investment, but is incidental to the bonds. Rev. Rul. 94-42 concludes that it is not consistent with the purposes of section 103 to extend the rationale of the bond insurance rulings to situations in which the purported insurance or other credit enhancement is either not incidental to the bonds or is a separate debt instrument or other investment. For this purpose, an insurance contract or similar agreement is treated as both incidental to the bonds and not a separate debt instrument or similar investment only if, at the time it is purchased, the amount paid 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.

If any amount paid or accrued on the G agreement is not appropriately treated as a payment by C for purposes of section 103 of the Code, those amounts are subject to the general tax rules for taxable investments. On the facts presented, the G agreement is a debt instrument subject to the rules of sections 1271 through 1275 of the Code.

An additional argument might be that the bond insurance revenue rulings do not apply to this transaction because the agreement is not insurance for federal income tax purposes. An analysis based on the definition of insurance could be more complex than an analysis focusing on the purposes of the bond insurance revenue rulings.

The fact pattern in Rev. Rul. 94-42 deals with bond insurance and not other

sorts of guarantee arrangements. The rationale of the revenue ruling, however, indicates that it applies to any other types of guarantee arrangements, however labelled.

4. Analysis of "Phoney Bond Insurance" Purchased at Original Issuance

The technical analysis of the transaction would be somewhat different if the insurance were purchased by the issuer at the time of issuance of the bonds. In that case one analysis would be that the "insurance" is a nonpurpose investment purchased by the issuer with bond proceeds. The transaction would be directly subject to the restrictions of section 148. The bonds would be arbitrage bonds because the investment would have a yield of 9.3 percent, while the bond issue would have a yield of 7.0 percent.

The issuer could be expected to argue that the bonds are not arbitrage bonds because the "insurance" is a "qualified guarantee" under. 1.148-4(g) of the final arbitrage regulations. This section provides that fees for qualified guarantees are treated as interest payments for the purposes of computing bond yield. With an initial "interest payment" of $14x (the payment to **G**), the bond issue would have a yield about equal to 9.3 percent.

It is highly questionable, however, whether this sort of arrangement would be treated as a qualified guarantee under the final arbitrage regulations. 1.148-3(g)(3) provides that a qualified guarantee must be a guarantee in substance. This means, among other things, that the guarantor must not expect to make any payments under the guarantee (with certain technical exceptions). Under the "phoney bond insurance" fact pattern, it seems clear that the guarantor expects to make payments because there is significant risk that the revenue from the facility cannot support the bonds and because the amount paid for the "premium" is sufficient to pay substantially all of the debt service of the bonds.

Similar provisions treating fees for bond insurance were contained in 1.103-13(c)(8) of the former arbitrage regulations and 1.148-3T(b)(12) of the rebate regulations.

3. INTRODUCTION TO TARGETED ENFORCEMENT INITIATIVES

Use of Tax-exempt Bond Proceeds to Purchase Investments at Greater Than Fair Market Value

1. Background

The yield restriction and rebate rules of section 148 effectively cause a market distortion: issuers may have no financial incentive to invest at the best possible yield because they cannot retain investment profits. An issuer that pays more than fair market value for investments effectively transfers arbitrage profit to the seller of the securities (rather than to the federal government).

This concern is most likely to be a problem when a large portion of the proceeds of a bond issue is invested for a long period of time. This situation occurs in advance refunding issues and may occur when an issuer invests bond proceeds in a guaranteed investment contract (or "GIC"). A GIC will be defined later in this subchapter.

2. Purchase of Open Market Treasury Securities for Advance Refunding Escrows

State and local governments commonly issue tax-exempt advance refunding bonds. This occurs when an issuer invests the proceeds of a refunding bond issue in an escrow that is used to redeem a prior bond issue more than 90 days after the issue date of the refunding bond issue. If the bond issue is redeemed within 90 days of the refunding, it is a current refunding rather than an advance refunding. In recent years securities placed in these advance refunding escrows have commonly been invested for as long as 8 years (and are sometimes invested for a much longer period). The investment of proceeds of advance refunding issues is subject to the yield restriction and rebate requirements of section 148. This means in general that the yield on the investments cannot be greater than the yield on the refunding bond issue.

In most cases, issuers enter into a purchase contract with an underwriter to sell the bonds on a date (the "sale date") that is two to three weeks before the issue date. Because the sizing of the bond issue depends upon the investments in the escrow, the issuer also typically needs to lock in its investments for the escrow on the sale date. The "sizing" of an issue is a determination of how much needs to be borrowed. The issuer may choose to subscribe for United States Treasury

Obligations -- State and Local Government Series ("SLGs") at designated below-market interest rates. The issuer may also choose, however, to purchase Treasury securities (or, in some cases, obligations collateralized or secured by Treasury securities or federally guaranteed) on the open market for the refunding escrow. In this case, the issuer typically enters into a contract on the sale date to purchase the securities for delivery two or three weeks later on the issue date. The contract is evidenced by a confirmation sent by the seller of the securities, which will often state that the contract is contingent on the closing of the refunding bond issue. If the yield on the open market securities exceeds the bond yield, the issuer will purchase special low-yielding SLGs at the end of the escrow term to blend down the overall yield on the investments (that is, lower the combined investment yield).

An example will help to understand the problem. Assume that State A issues $100 million principal amount of advance refunding bonds at par. The issue has an annual yield of 6 percent, compounded semiannually. All of the proceeds will be invested in an advance refunding escrow to pay off prior bonds. The investments have a weighted average maturity of 5 years. The issuer decides to purchase United States Treasury securities on the open market for the escrow from the bond underwriter.

To comply with arbitrage restrictions, the investments in the escrow cannot have a yield greater than 6 percent (treating all of the Treasury securities as one combined investment). The $100 million paid by the state for the Treasury securities gives the escrow a yield of 6 percent. Assume that, on the date that the Treasury securities are purchased, however, Treasury securities for the escrow could be purchased with a yield of 6.2 percent. This means that the fair market value of the Treasury securities was only about $99 million. The state pays $1 million too much for the investments, but does not suffer any financial loss, because it is not permitted to keep the $1 million arbitrage profit that it could have earned. Instead, the $1 million profit is in effect transferred to the underwriter.

This example makes the important point that superficially small differences in yield -- in this case 20 basis points (two-tenths of one percent) -- can result in significant abuse.

3. Determining Fair Market Value of Open Market Treasury Securities

Determining the fair market value of investments may require detailed fact gathering and financial analysis. The following discussion highlights some of the

factors that will need to be addressed.

Daily bid and asked yields for the different maturities of Treasury securities are published in The Wall Street Journal and are available from other sources. These published quotations are useful guidelines to determine fair market value. In specific cases, however, a number of factors may be relevant to this factual determination, including the following:

(1) Intra-day market variations. Published prices and yields are usually quoted as of a particular time during the day. These yields may fluctuate considerably during the day. Therefore, the published yields are not always exactly representative of market conditions when the securities are actually purchased

(2) Limited information from single source quotations. The Wall Street Journal publishes quotations for Treasury strips from a single firm, Bear, Stearns & Co. It is possible that quotations from other firms may not be exactly the same. A Treasury "strip" refers to an investment that is a portion of the payments to be made on a Treasury security, such as all of either the principal or interest payments.

(3) Impact of large purchases. In some cases the refunding escrow may require the issuer to purchase a very large amount of a particular maturity. The claim is sometimes made that the purchase itself can affect the market price of Treasury securities of that maturity, because the current owners learn of the need to purchase a large block of securities. In general this should only be a factor in extraordinary cases.

(4) Impact of forward purchase. Usually the seller agrees to deliver the Treasury securities to the issuer two or three weeks after the agreement is entered into. The issuer therefore purchases a "forward contract" for the delivery of the securities, not just the Treasury securities themselves. Some assert that the fair market value of this forward contract may be significantly different than the value of the securities on the date of the agreement. This issue is discussed at greater length below.

4. Fair Market Value of a Forward Contract to Deliver Treasury Securities

Assume that, in the example described above, the underwriter acknowledges that it purchased the Treasury securities for $99 million and resold them to the state on the same day for $100 million. The underwriter asserts that the $1 million difference is justified because it is required to hold the securities for two weeks before the bond issue closes. If the bonds are not issued, the issuer will not be required to make the purchase, and the underwriter will be left holding the Treasury securities. In that instance, if interest rates have risen, the Treasury securities may have declined substantially in value. For example, if interest rates rise to 6.4 percent for those maturities, the securities will only be worth about $98 million and the underwriter will suffer approximately a $1 million loss. The underwriter characterizes the fee as compensation for taking this risk of loss.

Placing a high value on the risk taken by the "forward contract" seller is questionable for a number of reasons. The risk that a municipal bond issue will not close on schedule is usually very remote. In addition, the factors that would prevent closing a bond issue on a scheduled date are generally unrelated to interest rate fluctuations. For example, an unexpected law suit or change in applicable law might cause an issue not to close. In this light, the valuation methodology used in the example which seeks to compensate the forward contract seller $1 million may be unacceptable as a matter of law because (1) it takes into account only downside risk and (2) it greatly overvalues the cost of downside risk. In other words, by entering into the forward contract the seller has written a contingent option to the issuer to sell, but the issuer has also written a contingent option to the seller to buy. The contingency does not favor either option, and it is remote.

Moreover, in many cases the sellers of open market escrow securities may actually profit even if they sell the securities to issuers at their cost. This is because the cost of carrying the securities (at a short term rate) is often less than the yield on the securities (usually a longer term rate).

A different starting point for the analysis is that fair market value of the forward contract should reflect the implied forward rate (which is derivable from the Treasury obligation yield curve). When this yield curve is upward sloping, the fair market value of the forward contract will always be less than the fair market value of the securities on the sale date. One approach to consider is whether the implied forward rate should be adjusted to take into account the seller's short-term cost of borrowing (which will be somewhat higher than the short-term Treasury yield).

An argument may perhaps be made that fair market value should reflect the seller's exposure to market risk, even though the risk of gain is the same as the risk of loss. Even if so, the cost of risk exposure should be a fraction of the cost to hedge downside risk, and even that fraction should be further reduced by the remoteness of the contingency.

5. Additional Issues

Giving consideration to the following factors may be useful in selecting cases for further development:

(1) Bond issues with "positive arbitrage" potential. In many advance refunding issues, the escrow has "negative arbitrage." This means that the issuer suffers an investment loss. For example, the yield on an issue may be 6 percent, but the issuer may be able to purchase only investments yielding 5.8 percent. Bond issues where investment earnings are possible are more likely to involve arbitrage abuse, for a number of reasons. First, in "negative arbitrage" situations, issuers that pay more than fair market value for investments in effect pay for the extra cost out of their own pockets. This in general means that in these situations issuers may be more attentive to the price paid for the securities. Second, issues that have "negative arbitrage" are less likely to involve technical arbitrage abuse, because, even taking into account the fair market value yields of investments, no investment profit is earned.

Whether an issue has the potential for investment profit depends on a number of factors, including the date the bonds are sold, the date the investments are purchased, the yield on the issue, the length of time bond proceeds are invested, and general market conditions (such as the slope of the yield curve for Treasury securities). As a practical matter, there have been periods over the past several years when nearly all advance refunding issues experienced negative arbitrage.

(2) Bond issues where the seller of the investments is a participant. In many cases the seller of the investments may be a financial advisor or underwriter for the bond issue. This situation raises a potential problem because the amount that an issuer pays in

excess of fair market value for investments in effect may be compensation for other services. In addition, financial advisors generally have an obligation to render impartial financial advice to issuers. If a financial advisor is the seller of securities to an issuer, there may be no other participant to advise the issuer about whether the price is fair market value.

6. Guaranteed Investment Contracts

In general, a guaranteed investment contract is an investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate. For example, suppose an issuer issues tax-exempt bonds to finance a $100 million construction project. It expects to make payouts over the next three years to build the project. In order to lock in an investment rate it could enter into a contract with a bank or other financial institution to invest all of the proceeds. The contract would provide the issuer with a guaranteed rate of return -- 7 percent, for example -- and yet permit the issuer to draw down funds whenever needed for project costs. Guaranteed investment contracts are often entered into for bona fide governmental purposes and are not inherently abusive.

On the other hand, guaranteed investment contracts present unique possibilities for abuse. A GIC is one way for an issuer to lock in an arbitrage profit. In addition, because GICs are "custom" investments, they are generally more difficult to value than many other types of investments that are widely traded, such as Treasury securities. Largely because of these valuation difficulties, the final arbitrage regulations under section 148 provide that issuers may establish fair market value of a GIC by obtaining three competitive bids from providers.

One particular problem that may arise with GICs is finder's fees that are paid to bond issue participants. For example, suppose that an underwriter arranges to invest the proceeds of a $100 million tax-exempt bond issue with a bank that provides a guaranteed investment contract. In exchange for placing the investment, the bank pays the underwriter $1 million. Depending upon the facts and circumstances, the proper legal analysis may be that the $1 million should be taken into account by the issuer in determining yield on the investment. In other words, the issuer may have paid $100 million for an investment with a fair market value of $99 million.

7. Relevant Authority

Section 148(a) provides that a bond is a taxable arbitrage bond if any portion of the bond proceeds are "reasonably expected" on the issue date to be used to acquire higher yielding investments. Section 148(b)(1) defines "higher yielding investments" as any investment property that produces a yield over the term of the issue that is materially higher than the yield on the issue. Section 148(f) provides in general that a bond is an arbitrage bond unless any profits from the investment of bond proceeds (in excess of the bond yield) are rebated to the United States. The rebate requirement of section 148(f) is not based on issue date expectations, but is rather based on actual earnings.

Section 1.148-2(d)(2) of the regulations defines "materially higher yield" for investments in a refunding escrow as 0.001 of 1 percent higher than the bond yield. Section 1.148-6(c) provides that gross proceeds of an issue are not allocated to a payment for a nonpurpose investment in an amount greater than the fair market value of that investment on the purchase date. For this purpose fair market value is adjusted to take into account "qualified administrative costs". Section 1.148-5(e)(2) defines qualified administrative costs as "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." Section 1.148-5(d)(6)(i) defines fair market value conventionally as the price at which a willing buyer would purchase from a willing seller in a bona fide, arm's-length transaction. Fair market value is determined as of the trade date rather than the settlement date. In addition, in general "an investment that is not of a type traded on an established securities market, within the meaning of section 1273, is rebuttably presumed to be acquired or disposed for a price that is not equal to its fair market value." Section 1.148-5(d)(6)(ii) establishes a three-bid fair market value safe harbor for guaranteed investment contracts. Forward contracts for advance refunding escrows generally are not "guaranteed investment contracts" for the purposes of this safe harbor.

8. Additional Technical Considerations

Use of tax-exempt bond proceeds to purchase investments at greater than fair market value could cause the bond issue to violate the arbitrage restrictions of section 148. In some cases, such a purchase could cause a bond issue to violate the 2 percent limitation on issuance costs financed with bond proceeds contained in section 147(g) for private activity bonds. The following considerations may be particularly useful to keep in mind as cases are developed.

(1) Rebate and yield restriction. An arbitrage violation can be either a yield restriction problem (section 148(a)) or a rebate problem (section 148(f)). Rebate problems can usually be cured by the issuer by making a payment to the United States. Yield restriction problems in many cases cannot be cured by a payment to the United States. (See however, 1.148-5(c), which permits issuers to make certain "yield reduction payments.")

Rebate violations, however, may be easier to establish than section 148(a) violations, largely because section 148(f) in general requires continued compliance based on actual facts. In contrast, the yield restriction rules of section 148(a) are largely based on the issuer's reasonable expectations as of the issue date. For bonds issued before August 15, 1993, the arbitrage certification provision of 1.103-13(a) of the former regulations merits serious consideration when a section 148(a) violation is asserted. This means that the arbitrage certification contained in a bond transcript should be carefully considered. It is important to note that an issuer's actual expectations may not meet the reasonableness requirement.

(2) Yield Blending. In certain cases the final arbitrage regulations permit issuers to "blend" investments in an advance refunding escrow with investments in other funds, such as a construction fund or reserve fund. This "blending" automatically occurs when a rebate computation is made, because all investments purchased with tax-exempt proceeds are taken into account. For yield restriction purposes, "blending" can occur primarily when an issuer waives its right to invest a fund at unrestricted yield under 1.148-2(h). See also 1.148-5(b), which defines different classes of investments for yield restriction purposes. This means that it is possible in certain cases for an advance refunding escrow to be invested at a materially higher yield without causing the issue to become an arbitrage bond.

(3) Brokerage commissions. As is described above, 1.148-5(e)(2) in effect gives issuers credit for the cost of reasonable brokerage commissions for investments purchased with tax-exempt bond proceeds. In the example discussed above, suppose that an issuer pays $100 million for investments with a

fair market value of $99 million. If a reasonable brokerage fee is $100,000, then fair market value of the investments is treated as $99,100,000. In that case, the issuer has overpaid by $900,000, rather than $1,000,000. A special limitation for brokerage commissions paid for guaranteed investment contract appears in 1.148-5(e)(2)(iii).

4. CAPITAL EXPENDITURES TAKEN INTO ACCOUNT FOR PURPOSES OF THE $10 MILLION SMALL ISSUE ELECTION

1. Introduction

The Code specifically provides for tax-exemption of bonds used to finance certain small projects to be used and paid for by private users. To meet this provision, bonds are limited to a face amount of $1 million dollars, unless the issuer elects to have a $10 million small issue election apply. If this election is made, certain other costs are taken into account in addition to the face amount of the bonds in determining compliance with the $10 million small issue election. This article explains the capital expenditure limitation to the $10 million small issue election through a discussion drawn largely from fact patterns in revenue rulings. Although determining whether interest is exempt from taxation requires a number of considerations, this article is limited to the capital expenditure limitation to the $10 million small issue election.

2. Background and Code Provisions

State and local governments issue bonds to help private parties finance projects. In a typical structure, an issuer sells bonds and loans the proceeds to a developer or other private user, who may also be referred to as a "conduit borrower." These financings typically will also involve a trustee, who is responsible for lending the bond proceeds to the developer or other private user and for making payments to the bondholders. The debt service on the loan between the issuer and the conduit borrower will match the debt service on the bonds, so that revenues received by the trustee under the loan agreement will repay the bondholders.

Section 103(a)(1) provides that gross income does not include interest on the obligation of a State or a political subdivision of a State. Under section 103(b)(1), however, interest on a "private activity bond" is not excludable unless it is a "qualified bond." A "private activity bond" is a bond the proceeds of which are used for any private business use and the payment of which is secured by or to be derived from an interest in property used or to be used for a private business use. The term "private activity bond" also includes a bond the proceeds of which are used to make loans to private persons. Each of these tests has a percentage threshold. Under the 1954 Code, the term "industrial development bond" was used to describe these bonds.

If a State or local government were to use the conduit financing structure described above to help a private person finance a project, the structure would run afoul of the private activity bond test and the bonds would not be tax-exempt unless an exception were met. Several exceptions are listed in section 141(e). One exception applies to a qualified small issue bond. Thus, the interest on a qualified small issue bond is excluded from gross income.

Section 144(a) defines a qualified small issue bond as a bond the aggregate authorized face amount of which is $1,000,000 or less and 95 percent or more of the net proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to depreciation.

After December 31, 1986, qualified small issue bonds can only be used to provide manufacturing facilities. The term "manufacturing facility" is defined to include any facility that is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of that property). The term also includes facilities that are directly related and ancillary to a manufacturing facility if (i) those facilities are located on the same site as the manufacturing facility, and (ii) not more than 25 percent of the net proceeds of the issue are used to provide those facilities.

Under Code section 144(a)(4), an issuer may elect to apply the qualified small issue exception by substituting $10,000,000 for $1,000,000. If the election is made, the aggregate face amount of the bond issue, which cannot exceed $10 million, will be determined by taking into account the face amount of the bonds to be issued, the outstanding face amount of any prior qualified small issue bonds (known as "exempt small issues" under the 1954 Code), and the aggregate amount of certain capital expenditures. Thus, for the bonds to qualify for the $10 million small issue election, the amount of the issue, the face amount of outstanding prior exempt small issues, and the amount of the includible capital expenditures cannot exceed $10 million.

A capital expenditure is included in the limitation if:

a. The capital expenditure was financed other than out of the proceeds of the issue in question and prior outstanding exempt small issues;

b. The capital expenditures were paid or incurred during the six-year period that begins three years before the date of issuance of the issue in question and ends three years after such date;

c. The principal user of the facility in connection with which the property resulting from the capital expenditures is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or are two or more related persons;

d. Both facilities referred to in (c) were (during all or part of the six-year period) located in the same incorporated municipality or in the same county (outside of the incorporated municipalities in that county); and

e. The capital expenditures were properly chargeable to the capital account of any person or State or local government unit (whether or not that person is the principal user of the facility or a related person) determined, for this purpose, without regard to any rule of the Code that permits expenditures properly chargeable to capital account to be treated as current expenses.

Under the Code and the regulations, the limitation takes into account a broad range of expenditures. The reasons for the broad sweep of the capital expenditures limitation are indicated in the following statement by Senator Long:

> **[T]he amendment provides an alternative to the $1 million exemption of present law. This alternative, which is elective, allows a governmental unit to issue industrial revenue bonds for use by a private concern up to a level of $5 million [the level has been $10 million since January 1, 1979] without the interest on the bonds being taxable, if a limitation, designed to assure the retention of the small business purpose of the exemption, is satisfied. Under this requirement the $5 million limitation is applied to the amount of bonds issued by the governmental unit for the concern, plus any capital expenditures in that governmental unit by the same concern, or by related persons, made within the 6-year period beginning 3 years before and**

ending 3 years after the bonds are issued and financed from other sources. In other words, a person may not use an exempt $5 million bond issue to construct part of a facility and then use other funds for further construction of that facility or facilities in the same town or other governmental unit within a 6-year period.

114 Cong. Rec. 29, 891-92 (1968).

Despite the wide variety of capital expenditures taken into account under the $10 million small issue election, there are, as described below, certain capital expenditures that are excluded.

The six-year measuring period begins three years before the issue date of the bonds. Thus, when a qualified small issue bond is issued, compliance with the rules concerning the $10 million small issue election requires an analysis of past capital expenditures. In addition, Code section 144(a)(4)(D) provides that, with respect to an includible capital expenditure made after the issue date of a bond, the bond will not lose its tax-exempt status by reason of that expenditure for any period before the date on which that expenditure is paid or incurred. Because the loss of tax exemption is prospective, some monitoring of the capital expenditures made after the bonds are issued is necessary in order to assure that the exemption will continue. An understanding of the capital expenditures taken into account in the limitation is therefore essential.

3. Capital Expenditures Taken Into Account

The $10 million small issue election is best understood by examining those components of the limitation that give rise to the most significant issues. These include determining who is a principal user, where facilities are located, when the expenditure is made, what is a "capital expenditure", how is an expenditure "with respect to" a facility, and which capital expenditures are excluded.

A. Who is a Principal User?

When the $10 million small issue election is made, the prior outstanding tax-exempt qualified small issue bonds and capital expenditures to be taken into account must be connected to facilities used by the same principal user or by two or more principal users who are related persons. Although final regulations (which may be relied upon as authority) defining the term "principal user" have not yet been published, section 1.103-10(h) of the Proposed Income Tax Regulations

generally provides that the term "principal user" means a person who owns, leases, purchases the output of, or otherwise uses more than 10 percent of the facility, as determined by the fair market value of the portion of the facility being used.

Under section 144(a)(3), for purposes of a qualified small issue bond, a person is a "related person" to another person if the relationship between them would result in a disallowance of losses under section 267 (relating to disallowance of losses between related taxpayers) or section 707(b) (relating to losses disallowed between partners and controlled partnerships). Persons are also treated as related for purposes of a qualified small issue bond if they are members of the same controlled group of corporations, as defined in section 1563(a) (relating to the definition of a controlled group of corporations), except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in section 1563(a). Under section 1.103-10(e), the determination of whether a person is related to another person is made on the date the bonds are issued.

B. Where Are Facilities Located?

In determining whether a capital expenditure must be taken into account for purposes of the $10 million small issue election, an important factor is the location of the facility to which the capital expenditure relates.

(1) Incorporated municipality: When determining which capital expenditures are includible for purposes of a $10 million small issue election, an incorporated municipality and the county within which it is located are treated as separate jurisdictions. Capital expenditures made in the county do not have to be taken into account by the municipality, and vice versa. Townships or towns will qualify as "incorporated municipalities" if they have substantial governmental powers and are recognized as municipal corporations by state statutes or the highest state court. Rev. Rul. 80-136, 1980-1 C.B. 25.

(2) Aggregating facilities: Under section 1.103-10(b)(2)(ii)(e) of the regulations, capital expenditures are includible when made with respect to a facility which, although located outside the issuer's jurisdiction, is contiguous to or integrated with a facility located within the issuer's jurisdiction. Rev. Rul. 75-193, 1975-1 C.B. 44, illustrates the operation of this rule. In this ruling, two related corporations, X corporation and Y

corporation, own contiguous parcels of land that are located in separate jurisdictions. Each corporation plans to construct a manufacturing facility on its land. The plants will have no physical interconnection, will be approximately 300 feet apart, and will not use common facilities. The plants will use dissimilar processes, produce different products, and have different production employees. The ruling holds that, in determining the aggregate amount of bonds city may issue under the $10 million small issue election to construct the manufacturing facility of corporation X, corporation Y's capital expenditures for its contiguous land and manufacturing facility must be taken into account. In determining whether two facilities are integrated, significant factors are the proximity of the facilities, as well as whether the facilities are involved in various stages of the same overall continuing manufacturing process. For instance, noncontiguous factories 1/2 mile apart, with one factory producing carpet yarn that will be used in the other to manufacture carpet, are integrated. Rev. Rul. 76-427, 1976-2 C.B. 28.

(3) Moved equipment: The cost of equipment purchased outside the jurisdiction but moved to a facility located within the jurisdiction is an includible capital expenditure so long as the expense was incurred within the six-year measuring period. For instance, say Company purchases $3 million of equipment more than three years before County issues $8 million of bonds. Company later moves the equipment into its factory in County from the equipment's original location in another jurisdiction. The transfer of the equipment into County does not cause the amount Company spends to acquire the equipment to be an includible capital expenditure since Company acquired the equipment more than three years before the issue date of County's bonds. However, if Company had acquired the equipment during the three year period before the date County issued the bonds, Company's cost would have been a capital expenditure for purposes of the $10 million small issue election, and the bonds could not have been issued as qualified small issue bonds. Section 1.103-10(g), Example (12).

More than one jurisdiction may have to treat the same expenditure as an includible capital expenditure. For instance, Rev. Rul. 82-162, 1982-2 C.B. 45, holds that the cost of equipment moved by a company to its plant located in a county from its plant located in another jurisdiction is a capital expenditure that must be included by the county for purposes of bonds it issued under the $10 million small issue election, even though the other jurisdiction has already treated the cost of the equipment as an includible capital expenditure. The other jurisdiction must also treat the cost of replacement equipment as an includible capital expenditure.

An expenditure for equipment will be excluded if the intent was to locate the equipment elsewhere, and, even though the purchase occurred within the six-year measuring period, the equipment is moved into the jurisdiction after the six-year period has expired. For example, in Rev. Rul. 83-18, 1983-1 C.B. 28, company, located in city, purchases equipment which it installs in another jurisdiction, intending to use it there for its entire useful life. The expenditure is made within three years after city issues bonds. After the six-year period has expired, company changes its plans and moves the equipment into city. The ruling holds that city is not required to treat the cost of the equipment as an includible capital expenditure. However, the equipment cost would have been includible by the city if the equipment had been moved into the city within the six-year measuring period.

A capital expenditure for equipment is also excludable if the equipment is only located in the jurisdiction temporarily or has no substantial connection to the jurisdiction. For instance, the cost of computers assembled within the jurisdiction but sent elsewhere for leasing need not be taken into account for purposes of the $10 million small issue election, if the computers are stored and maintained primarily outside the city, are located in the city only temporarily, and are not intended for use in the city. Rev. Rul. 85-112, 1985-2 C.B. 35. The expense of a major overhaul of a trucking company's trucks carried out in city is an excludable capital expenditure if the trucks have no substantial connection to and are not based in the city, the trucks move constantly through the operating system, and the trailers are interchanged with another company's trailers. Rev. Rul. 80-12, 1980-1 C.B. 23.

C. When is the Expenditure Made?

Three years before and after the issue date: A capital expenditure is includible for purposes of the $10 million small issue election if paid or incurred

during the six-year period that begins three years before the date the bonds are issued and ends three years after that date. A capital expenditure, such as a capitalized construction cost, is still includible even if the facility to which it relates will not be completed until after the six-year period has expired, so long as the cost was incurred during the six-year period. Rev. Rul. 74-485, 1974-2 C.B. 32. If equipment is to be delivered after the expiration of the six-year period, only that proportion of the cost equal to the percentage of the manufacturer's cost incurred before the expiration date of the six-year period is an includible capital expenditure. Rev. Rul. 78-347, 1978-2 C.B. 101.

D. What is a "Capital Expenditure"?

Neither section 144 nor the regulations define the term "capital expenditure" for purposes of the $10 million limitation, but both the Code and the regulations use the term. Although some items like buildings and equipment probably seem obvious, other items that may not come to mind immediately are also included.

(1) Capitalized interest: Interest that is paid or incurred during the construction period and is chargeable to capital account under section 266 must be treated as an includible capital expenditure, even if deducted currently for tax purposes. Rev. Rul. 75-185, 1975-1 C.B. 43. However, the interest must be incurred on a loan for the project. For instance, in Rev. Rul. 82-117, 1982-1 C.B. 19, a bank pays for the construction of a building from the accounts of its own depositors rather than from funds borrowed for the project. Interest paid by the bank to its depositors is held not to be an includible capital expenditure since amounts deposited by the bank's customers are received in the normal course of the bank's business. The interest is not on a loan incurred for the project.

(2) Covenant not to compete: The purchase of a covenant not to compete that is made in connection with the acquisition of a business, that is negotiated at arms' length, and that covers a specific time period and geographic area is chargeable to the purchaser's capital account and is an includible capital expenditure for purposes of the $10 million small issue election. Rev. Rul. 81-55, 1981-1 C.B. 52.

(3) Goodwill: An amount paid for goodwill in connection with the

acquisition of an ongoing business is chargeable to capital account and is an includible capital expenditure. Rev. Rul. 81-56, 1981-1 C.B. 53.

(4) Costs for the bond: Expenses paid or incurred in the issuance of the bonds, such as legal, recording, and underwriting fees, printing costs, and taxes, are includible capital expenditures. Rev. Rul. 77-234, 1977-2 C.B. 39. An amount spent to retire bonds is also an includible capital expenditure. In Rev. Rul. 76-98, 1976-1 C.B. 31, an issuing authority issues bonds to acquire a factory for a corporation. The issuer later redeems a portion of the bonds and issues more bonds under the $10 million small issue election to acquire another factory for the same corporation. The ruling holds that the issuer must treat the bond redemption expenditure as an includible capital expenditure for purposes of determining the aggregate face amount of the second bond issue.

E. How is an Expenditure "With Respect To" a Facility?

The statutory requirement that the capital expenditure be "with respect to" a facility in the same jurisdiction and with the same principal user has been broadly interpreted.

(1) No ownership requirement: A capital expenditure may be includible even if it does not relate to any facility owned by a principal user of the bond-financed facility or a related person. In Rev. Rul. 85-145, 1985-2 C.B. 37, a company leases and is the principal user of a building owned by an unrelated person. The company is to move to another bond-financed building in the same city once construction of the other building is finished. The owner of the building of which company is a tenant installs air conditioning required by other tenants and not by company. The ruling holds that owner's cost for the air conditioning is an includible capital expenditure even though company will vacate the building by the time the air conditioning is operational.

The cost of an in-kind dividend is also an includible capital expenditure. In Rev. Rul. 78-59, 1978-1 C.B. 30, a wholly-owned subsidiary manufactures storage

units and handling equipment that it distributes as an in-kind dividend to its parent company. The parent company is located in another county and will use the storage units and handling equipment in operating a warehouse, the construction of which will be financed with bonds for which the county plans to make a $10 million small issue election. The subsidiary's cost in manufacturing the items is an includible capital expenditure for purposes of determining the aggregate amount of bonds the county may issue.

(2) No reductions for temporary use: A company's purchase of mobile buildings for temporary use as offices while its new bond-financed facility is being constructed is a fully includible capital expenditure for purposes of determining the aggregate amount of bonds that may be issued for purposes of the $10 million small issue election. Rev. Rul. 75-208, 1975-1 C.B. 46.

(3) Research expenditures: Research and development expenditures are generally includible in the jurisdiction in which production is benefitted rather than the jurisdiction in which the research is carried out. [Note the exception to this general rule described below in section III.F.4.] In Rev. Rul. 77-253, 1977-2 C.B. 40, research is conducted in a plant located in county A for new product to be manufactured in counties B and C. The $10 million small issue election is unaffected in county A, but the cost of the research is held to be includible in counties B and C in proportion to the amount of new product made in each county.

F. Which Capital Expenditures Are Excluded?

Certain capital expenditures that would otherwise be taken into account are specifically excluded.

(1) Casualty replacement: Under sections 144(a)(4)(C)(i) of the Code and 1.103-10(b)(2)(iv)(c) of the regulations, any capital expenditure to replace property destroyed or damaged by fire, storm, or other casualty, to the extent of the fair market value of the property replaced, is not taken account for purposes of the $10 million small issue election.

(2) Change in law: Under sections 144(a)(4)(C)(ii) of the Code and

1.103-10(b)(2)(iv)(d) of the regulations, any capital expenditure required by a change made in federal, state, or local law after the issue date of the bond issue in question is excluded.

(3) Unforeseen circumstances or mistake of fact or law (with $1 million limit): Under sections 144(a)(4)(C)(iii) of the Code and 1.103-10(b)(2)(iv)(e) of the regulations, any capital expenditure not exceeding $1 million is excluded if it is required by circumstances that could not reasonably have been foreseen on the date of issue or if it arises out of a mistake of law or fact. For example, additional capital expenditures for landscaping, architectural changes, increased engineering fees, and boiler changes, incurred as a result of unforeseen erosion, weak soil support for building foundations, and fuel shortages, are excluded. Rev. Rul. 75-147, 1975-1 C.B. 41. However, expenditures that are reasonably foreseeable are not excluded. For instance, in Rev. Rul. 77-224, 1977-1 C.B. 25, company experiences an increase in business due to a new business method it develops for marketing the product of its plastic product molds. The ruling holds that the additional expenditures made in manufacturing the extra molds necessitated by the increase in business were reasonably foreseeable. The cost of the additional molds is thus not excludable under section 144(a)(4)(C)(iii).

(4) Section 41(b)(2)(A) research expenses: Under section 144(a)(4)(C)(iv) of the Code, any in-house research expenditures described in section 41(b)(2)(A) (employee wages for qualified services, supply costs, and payments to another person for the right to use computers in the conduct of qualified research), for which a deduction under section 174(a) is allowed and is actually taken, are excluded. For example, Rev. Rul. 85-142, 1985-2 C.B. 35, holds that expenditures by company for research relating to product to be manufactured in another jurisdiction in a bond-financed facility are not includible capital expenditures so long as the expenditures are described in section 41(b)(2)(A) and company deducts them under section 174(a). If company took no section 174(a) deduction, the expenditures would be includible.

(5) Charitable organizations: In Rev. Rul. 74-289, 1974-1 C.B. 32, a capital expenditure by a section 501(c)(3) charitable foundation trust is excluded for purposes of an exempt small issue for a wholly owned corporation where the expenditure relates to the trust's exempt activities rather than the operations of the wholly owned corporation.

(6) Tax-free exchange: If a corporation acquires the assets of another corporation in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, the expenditure by the corporation in acquiring the assets is excluded for purposes of the $10 million small issue election. Also, if property is transferred to a corporation solely in exchange for its stock or securities in a section 351(a) exchange, the issuance of the stock or securities is not treated as a capital expenditure for purposes of the $10 million small issue election. However, if either type of transaction occurs during the six-year measuring period, the transferor and the transferee are treated as related persons during the entire six-year period. Section 1.103-10(b)(2)(v). Also see Rev. Rul. 75-411, 1975-2 C.B. 41 (an expenditure by a corporation in a reorganization to acquire the stock of an unrelated corporation is excluded).

In Rev. Rul. 77-146, 1977-1 C.B. 24, a city plans to issue bonds under the $10 million small issue election, the proceeds of which will be lent to partnership A. The ruling holds that a transfer of a partnership interest by partnership A to partnership B in exchange for land is excluded for purposes of determining the aggregate amount of bonds city could issue for purposes of the $10 million small issue election, since the exchange between the partnerships is tax-free under section 721 and is thus comparable to an exchange of stock for property under section 351(a).

In Rev. Rul. 83-17, 1983-1 C.B. 26, a corporation acquires land located in city in exchange for land it no longer needs. Each tract of land has a fair market value of $4 million. Although the exchange qualifies for nonrecognition of gain

under section 1031, the ruling treats the exchange as an includible capital expenditure for purposes of $7.5 million of bonds city proposes to issue under the $10 million small issue election. The face amount of the bonds, when aggregated with the corporation's $4 million capital expenditure, will exceed $10 million and the interest on the bonds will not be excludable from gross income. Rev. Rul. 77-146 is distinguished on the grounds that where property is transferred to a partnership in exchange for an interest in the partnership, the new partner effectively retains an ownership interest in the land. However, where, as in Rev. Rul. 83-17, one parcel of land is transferred to another person in exchange for another parcel of land, it is the same as if the exchanged property is sold and the sale proceeds used to purchase the new property. The transferor has new property, with no interest in the old.

(7) Public utility: A capital expenditure is excluded if it is made with respect to property of a public utility company that is not the principal user of the facility financed by the proceeds of the bond issue in question, the property is used to provide gas, water, sewage disposal service, electric energy, or telephone service, the property is installed in or connected to the bond-financed facility but is not an integral part of the bond-financed facility, and the property is of a type normally paid for by the user in the form of periodic fees. Section 1.103-10(b)(2)(iv)(a).

(8) Customarily leased equipment: Under section 1.103-10(b)(2)(iv)(b) of the regulations, a capital expenditure made for equipment or other personal property by a person, other than the user of the equipment, who is the manufacturer of the equipment or a person engaged in the business of leasing equipment is an excluded expenditure if the equipment is leased by the manufacturer or person in the leasing business and is the type of property that is ordinarily the subject of a lease. Periodic rental payments made under a land lease are also excluded. Rev. Rul. 77-353, 1977-2 C.B. 44. However, if equipment that is customarily leased is instead purchased by a company for its own use, and then sold and leased back, the company's purchase price of the equipment is an includible

capital expenditure. Rev. Rul. 79-248, 1979-2 C.B. 41. On the other hand, if a company makes a purchase order and downpayment for equipment for its own use, but then cancels the order, the refunded downpayment is an excluded capital expenditure since, unlike in Rev. Rul. 79-248, the purchase is never completed. Rev. Rul. 80-162, 1980-1 C.B. 26.

4. Conclusion: Examination of Capital Expenditures

The distinctions drawn in this area illustrate the importance of extensive fact discovery when attempting to identify capital expenditures that should be taken into account for purposes of an issuer's $10 million small issue election. In addition, the varied nature of the fact patterns in the rulings discussed indicates the difficulty in trying to provide an all-inclusive method for identifying includible expenditures. An analysis of bond documents, Forms 8038 filed by the issuer, and depreciation deductions taken by a principal user of the facility or a related person may serve as a starting place. Particular attention should be paid to moved property and transactions such as sale/leasebacks and "leases" involving related parties.

5. AUDIT TECHNIQUES FOR MUNICIPAL BOND CASES

In this subchapter we will address procedures for auditing a municipal bond issuance. You will find that auditing a municipal bond issuance presents some unusual audit problems. This chapter will address some of those problems as well as highlight some auditing techniques that you may use in examining municipal bond cases.

1. Background

There are numerous means by which you may learn about a questionable bond issuance. In some cases, you will receive information about an issuance from the National Office. You may also find an issuance through a nationwide tax-exempt bond enforcement program that your district is implementing. In addition, you may be examining an exempt organization or other conduit borrower and find that a state or local government issued bonds and loaned the proceeds of that issuance to the organization under audit. Whatever the method for finding the issuance, if you have reason to believe that the bonds are not tax-exempt, there are a number of special considerations you should keep in mind as you further investigate the bonds.

In most cases, a review or audit of the bonds is completed at the issuer level. This means that if you are auditing a conduit borrower, such as a section 501(c)(3) organization, and believe that there may be a problem with the bonds, you will need to open an audit on the bonds at the issuer level. In doing your audit at the issuer level, you should realize that while issuers are not taxpayers with respect to the bonds, they have been afforded certain protection normally reserved for taxpayers, i.e., protection of taxpayer information.

Because your examination will not be at the taxpayer (i.e., bondholder) level, you will need to adjust your examination techniques. For example, you will probably find that a number of John Doe Summonses are needed throughout the examination. We discuss the John Doe Summons process below. Another example is that you will generally not be able to obtain extensions of the limitations period until late in your audit because you will not have the bondholders' names until then and, even after you have obtained the bondholders' names, securing extensions from the numerous bondholders may prove to be extremely difficult. Further, because we recommend that cases be "deemed defendable" by district counsel before bondholders are notified that their bonds are taxable, early

coordination with district counsel is strongly recommended. Thus, you will need to complete a thorough audit in a short period of time.

Given these concerns, your audit should be multifaceted. In particular, your audit will require 1) developing the case, 2) discussing settlement with the issuer, and 3) obtaining the bondholders' names in case the Service needs to issue statutory notices of deficiency to the bondholders. While a certain amount of case development must be completed before you seek a John Doe Summons to obtain the bondholders' names, you should not wait too long before beginning that facet of the audit. We will address each of the facets separately.

2. Developing the Case

There is no single audit technique that can be used for all municipal bond cases. There is, however, a process for approaching these cases that you may find useful. Briefly, that process involves 1) collecting the bond documents, 2) reviewing those documents to determine what representations they make about your issue, and 3) verifying those representations.

A. Collecting the Offering Documents

Once you have reason to suspect that a purported tax-exempt bond is taxable, you will first want to obtain the documents relating to the issuance. Generally, these documents can be found in the bond transcript. The bond transcript may be obtained from the issuer. The issuer may be a state or local government, certain political subdivisions of a state or local government (see Treas. Reg. 1.103-1(b)), or an entity that issues bonds on behalf of a state or local government (see Treas. Reg. 1.103-1(b) and Rev. Rul. 63-20, 1963-1 C.B. 24). The transcript is a "public record." If, however, you are unable to obtain a copy of the transcript from the issuer, other parties involved with the bond issuance, e.g., the entity that borrowed the bond proceeds, the bond counsel, and the bond trustee, should also have complete copies of the bond transcript.

B. Review of Offering Documents and Verification of Representations

Once you have collected the bond transcript, you will find that it contains a wealth of information about the bonds, the issuer, the conduit borrower (that is, the developer or section 501(c)(3) organization borrowing the bond proceeds), the security for the bonds, and the use of the bond proceeds.

The most important documents to examine include the official statement, the trust indenture or trust agreement between the issuer and the bond trustee, the loan agreement between the issuer and the conduit borrower, if any, the issuer's and conduit borrower's certificates, the no-arbitrage certificate, and the Form 8038. All of these documents, with appendices, will give you a good understanding of what the bond transaction was intended to accomplish.

You now need to determine what representations the bond documents make about your legal issue. You should then verify these representations. For example, if the bond proceeds were to be loaned to a section 501(c)(3) organization, but you have reason to believe that the borrowing organization was not a section 501(c)(3) organization, review the transcript for information on the organization. Assume that the transcript provides that the proceeds would be loaned to XYZ, a section 501(c)(3) organization. You should verify that the proceeds were indeed loaned to XYZ and that XYZ is in fact a section 501(c)(3) organization.

Another example is a case in which you have reason to believe that the bond proceeds were not spent for their intended use and were invested in a manner that earned arbitrage. Suppose you review the offering documents and find that the bond proceeds were to be used to build a courthouse. You go to the site where the courthouse was to be built and find a fast food restaurant. Upon questioning the issuer about the discrepancy, the issuer tells you that the bond proceeds remain with the trustee and will be used for the courthouse soon. Not only will you want to verify that the proceeds are with the trustee, but you will also want to determine the yield on investment of those proceeds. A variation of this second example is that when you visit the site, you find that the courthouse was built, but you have reason to believe that it was not built with proceeds from the sale of the bonds.

Tracing the Bond Proceeds

The second example and its variation raises an audit technique that you may find useful for a number of legal issues. That technique involves tracing the bond proceeds or "following the green." This technique is an important step in determining how the bond proceeds, and maybe certain other monies (i.e., replacement proceeds) were used. This technique could involve tracing the bond proceeds through the "hands" of a number of parties before finding their ultimate use. As you are doing this tracing it is helpful to ask yourself "do I know where the proceeds came from and do I know were they went?".

In tracing the proceeds, it is again useful to first look to the bond transcript

to determine how the proceeds were to be used. In the transcript, you may find an agreement between the issuer and a trustee bank, often called the indenture of trust or trust agreement, setting forth the trustee bank's responsibilities with respect to the bond proceeds. The agreement may provide that the bond proceeds would be transferred to the trustee and that the trustee would then open an account for the proceeds and monitor the disbursements from that account. You may also find that the trustee bank was required to file periodic reports with the issuer on the use of the proceeds.

Thus, the trustee bank may have valuable information to help you in tracing the funds. The trustee may be able to provide you with an accounting for the proceeds (you may have to issue a summons to the bank to obtain this information, see John Doe Summons below). For example, bank statements can be used to show the flow of funds into and out of the proceed's account. Withdrawal orders may be available to show the withdrawal of the proceeds and the reason for the withdrawal. Requests for dispersal of proceeds may also show the purpose of the withdrawal. Your information request to the bank should include a request for all relevant bank accounts, bank statements, wire transfers and/or checks, requisitions for disbursement of the proceeds, and reports.

If you are unable to determine the ultimate use of the funds with this documentation, it may be necessary to seek information from other parties that were involved in the flow of funds. For example, if the conduit borrower directed the trustee bank to send the proceeds to a second bank, you will need to determine what that second bank did with the proceeds. Keep tracing the bond proceeds until you have determined the ultimate use of those funds (e.g., expenditures associated with the project for which the bonds were issued).

If you are having trouble tracing the funds from the source, try tracing back from where you believe that the proceeds went. If you believe that the proceeds were used to purchase an investment, contact the person selling the investment to determine whether they have records showing where the funds for the investment came from. For example, if the funds were wired, there may be a record of the wire transfer and the account from which the funds were wired.

Because of the fungibility of money, you may not be able to trace the actual dollars that purchased the bonds. For example, assume the trustee bank distributed the bond proceeds (equal to $10X) to a third party that "commingled" those proceeds with other funds it held. Subsequently, that third party paid $10X from these commingled funds to purchase an investment contract that was pledged to

pay off the debt service on the bonds. In this situation, we may not be able to say that the proceeds from the sale of the bonds purchased the investment. You should, however, remember the replacement rules that may allow us to treat the pledged investment as bond proceeds, thereby avoiding the need for tracing of the actual dollars.

If the proceeds or replacement funds were held for a period before they were distributed for the ultimate use, you will also want to determine whether there was a yield on investment of those funds as well as how long those funds were earning yield before they reached their ultimate use.

You may find it very useful to draw a flow chart for the actual use of the bond proceeds as well as one for the use of proceeds as described in the bond transcript. To the extent that there is a discrepancy between the two charts, ask yourself whether that discrepancy is legally significant.

C. Sources of Information

We discussed above some of the sources for obtaining information. We discussed the bond transcript and how important it is that you obtain and carefully review the transcript. We also discussed information you can obtain from the trustee bank.

Your information sources will vary widely depending on the legal issues. For example, if you believe that the principal user of a small issuance exceeded the $10 million cap of section 144(a)(4), you will need to review the principal user's and any "related" entities' capital expenditures for a six year period beginning three years before the date that the bonds were issued. Your primary source of information for this examination will probably be the financial records of the principal user of the facility and entities related to the principal user.

If you believe that the issuer intentionally acted to earn arbitrage (i.e., purchased a higher yielding investment) after the bonds were issued, you will want documents showing the issuer's intent. You may want to obtain any internal memoranda or correspondence the issuer has with respect to the purchase along with any correspondence the issuer had with the seller of the investment. If the issuer indirectly purchased the investment property, you should trace correspondence between the issuer and the ultimate buyer of the investment property to determine if the issuer was behind the purchase of the investment. As with tracing the proceeds, you may need to start with the seller of the investment

and trace backwards.

If you believe that the issuer could not have reasonably expected to build the project for which the bonds were issued, you will need to review the no-arbitrage certification and to "go behind" the certification. To "go behind" the certification, you will review the information that was available to the issuer in making its decision on the issuance. The information to review should include the feasibility study on the project to be financed with the bonds.

We have just mentioned a few of the possible legal issues and some of the sources of information to develop those issues. While you will find many other types of legal issues, you will find, as a general matter, that the issuer and the conduit borrower, if any, have considerable information. You may also want to interview the other parties to the transaction such as the bond counsel, the underwriter, the trustee bank, and the provider of credit enhancement. If an interview is not feasible, a third-party contact should be made to obtain important documents and information.

Also, do not overlook the benefits of the obvious information sources. For example, if you are concerned with whether the issuer paid above market value for an investment, such as Treasury securities, financial publications, including the Wall Street Journal, are an excellent starting point for determining the market value.

If you find that you need specialists to help verify representations in the transcript, see our discussion on referrals for specialists below.

D. John Doe Summonses

Throughout this chapter we have referred to the need for John Doe Summonses. This need arises when you do not have a bondholder's name and the party from whom the information is sought is unwilling to voluntarily provide the information without a summons. For example, if you need information from the trustee bank on how the bond proceeds were disbursed and the bank requests a summons before it will provide you with the information, you will need to obtain a John Doe Summons unless you already have a bondholder's name. As discussed further below, you will also probably need John Doe Summonses to obtain the bondholders' names.

Because obtaining a John Doe Summons takes time, and because you may

need to issue several layers of summonses (see our discussion on obtaining the bondholders' names below) to obtain the bondholders' names, it is extremely important that you give priority to processing the summonses. Your district counsel can assist you in preparing a request for a John Doe Summons. You can find a detailed discussion of John Doe Summonses in the Internal Revenue Manual at IRM 4022.13

E. Arbitrage Calculations

Another important step in the development of your case may be to complete arbitrage calculations. This calculation will help you determine whether the issuer failed to yield restrict, see section 148(a), or whether there was rebatable arbitrage earned on the bonds, see section 148(f).

The regulations, beginning at Treas. Reg.. 1.148-1, provide details on calculating arbitrage. While the bond program is in its initial stages, you can request that the National Office assist you with the arbitrage calculation. Before beginning your calculation, you will find it useful to collect the following information.

(1) The date of issue of the bonds. This may be found on the bonds or on the Form 8038-G. Treas. Reg.. 1.150-1(b) states that the date of issue of a bond is the first day on which there is a physical delivery of the written evidence of the bond in exchange for the purchase price. This day is not earlier than the first day on which interest begins to accrue on the bond for federal income tax purposes.

(2) Determine whether the bonds are still outstanding.

(3) Yield on the issue

a. Determine the issue price. You will need to verify information found on the Form 8038-G and the official statement. Treas. Reg.. 1.148-1(b) states that the term "issue price" has the meaning given such term by I.R.C. . 1273 and 1274. Treas. Reg.. 1.148-1(b) also states that if bonds are publicly offered (i.e., sold by the issuer to a bond house, broker, or similar person acting in the capacity of underwriter or wholesaler) and are not issued

for property, the issue price of the bonds is determined on the basis of the initial offering price to the public at which price a substantial amount of the bonds was sold to the public.

b. The payments for principal and interest. You should provide how the interest payments are computed and when they are due. A total debt service schedule usually will not be on the bond form, but will be contained in the final official statement. The information needed to verify the correctness of this information will appear on the bonds.

c. The stated redemption price. This may be found on the bonds. Treas. Reg.. 1.148-1(b) states that the stated redemption price of a bond means the redemption price of an obligation under the terms of the obligation, including any call premium.

d. The final maturity date of the issue.

e. Whether the bond is subject to early redemption, either mandatory or optional. If the bonds are subject to early redemption, determine the date and price for the redemption. This information may be found on the bonds.

f. Whether there is any credit enhancement that is a qualified guarantee under Treas. Reg.. 1.148-4(f). Determine the amount of any qualified guarantee fees and the dates on which the fees are paid or are reasonably expected to be paid. The official statement should indicate whether there is any credit enhancement.

g. Determine whether the issuer has entered into a contract to hedge its risk of interest rate changes with respect to the issue. See Treas. Reg.. 1.148-4(h).

h. Determine whether the issuer has transferred, waived, modified, or similarly conveyed any right that is part of

the terms of a bond or is otherwise associated with a bond (e.g., a redemption right), in a transaction that is separate and apart from the original sale of the bond. See Treas. Reg.. 1.148-4(b)(4).

(4) Nonpurpose investments and receipts.

a. Identify nonpurpose investments allocated to the issue. The allocation rules may be found at Treas. Reg. . 1.148-6.

b. Construct a schedule showing the amounts and dates of payments and receipts for the nonpurpose investments. This information usually will not be available from the bond transcript (which is prepared as of the issue date). You may need to obtain information such as the requisitions to the bond trustee for disbursement of the proceeds and the relevant account records from the trustee.

c. Determine whether the issuer has made any rebate payments.

(5) Elections. Locate any elections made by the issuer for the issue. These elections should be found in the issuer's books and records.

F. Referrals

As you are developing your case, you may determine that you need a specialist. For example, you may find it necessary to determine the economic life of the property being financed with the bond proceeds for purposes of section 147(b). A referral to the Economist Assistance Program (IRM 42(12)0) is made on Form 9276. A referral to the Engineering Program (IRM 42(16)0) is made on Form 5202. Referrals to either of these programs must be coordinated with the Examination Division.

G. Obtaining Help

We strongly recommend that you ask your district counsel for help early in

your audit. You can also contact your region's district counsel bond liaison. The liaison are:

Midwest:	**Jeff Ehrlich**	**CC:MW:SPR**	**(217) 527-6000**
Southeast:	**Bonnie Cameron**	**CC:SE:ATL**	**(404) 331-6073**
N. Atlantic:	**Theodore Leighton**	**CC:NA:BRK**	**(516) 832-2401**
Mid-Atlantic:	**Karen Chandler**	**CC:MA:WAS**	**(202) 634-5411**
Southwest:	**Mark Scott**	**CC:SW:DAL**	**(214) 308-7900**
Central:	**Eric Nemeth**	**CC:C:DET**	**(313) 226-4790**
Western:	**Clifton B. Cates**	**CC:W:LA**	**(213) 894-4663**

There are also people at the National Office that are available to assist you in developing your case. These people are:

Office of the Assistant Commissioner (Employee Plans/Exempt Organizations)

Joe Grabowski	(202) 622-5070
Debra Kawecki	(202) 622-6858

Office of the Assistant Chief Counsel (Field Service)

Rebecca Harrigal	CC:DOM:FS:FI&P	(202) 622-7870
Marsha Keyes	CC:DOM:FS:FI&P	(202) 622-7870

Office of the Assistant Chief Counsel (Financial Institutions & Products)

Michael G. Bailey	(202) 622-3980
Lon Smith	(202) 622-3980

3. <u>Settlement Guidelines</u>

Generally, we prefer to resolve violations of the tax-exempt bond rules at the issuer level through a closing agreement. Accordingly, you should send a letter to the issuer noting the violations, stating that you believe that interest on its bonds may not be exempt and offering the issuer the opportunity to resolve the case through a closing agreement with the Service. This letter should set a time for settlement discussions, after which time the Service may begin taxing the

bondholders. Generally, the Service has allowed the issuer 60 days. At the end of this time, if the issuer has made good faith efforts to settle the case, you and your manager may decide to delay proceeding against the bondholders. In making your decision, you should remember that the bondholders' statutes of limitations are running throughout your examination and settlement discussions.

If after developing the case, it appears that the issuer is amenable to settlement, you will need to submit the proposed closing agreement with supporting documentation to the National Office prior to beginning negotiations. This material, along with a memorandum setting forth the facts, law and analysis should be sent to the Office of the Assistant Commissioner (EP/EO) Field Compliance.

The terms of the closing agreement should be drafted with the assistance of your district counsel in conjunction with the Office of the Assistant Chief Counsel (Field Service).

4. Taxing the Bondholders

A. Obtaining the Bondholders' Names

The third facet of your audit is obtaining the bondholders' names, which will probably require the use of John Doe Summonses. Generally, a summons is issued to the party who is responsible for paying the interest to the bondholders. In a large number of cases, this party is the trustee bank.

The information that you obtain from this summons may show that the interest is being paid to a clearinghouse. It is unlikely that the clearinghouse is the actual owner of the bonds. Accordingly, another John Doe Summons must be issued to the clearinghouse. You may find that you need to use several tiers of summonses. You may be able to avoid separate John Doe Summonses for each tier by obtaining a continuing John Doe Summons. Your district counsel can advise you on the feasibility of such a summons. If you find that the bonds are held in a mutual fund, you should contact you district counsel for assistance.

As discussed above, obtaining a John Doe Summons requires time for review by your district counsel, the National Office, the Department of Justice and a court. During this time, the bondholders' statutes are running. Accordingly, it is critical that you begin the summons process early.

B. Taxing the Bondholders

Your case is now developed and you have been unable to negotiate a settlement with the issuer. You have two more steps to take before you can begin the process of taxing the bondholders. These steps are really "safety valves." As we indicated above, the taxpayers generally purchased their bonds under the representation that they were tax-exempt. Moreover, because the taxpayers were not involved in the issuance of the bonds or the use of the bond proceeds they do not have the information that you will need to develop the case. Accordingly, you should not approach the bondholders before you have a high level of certainty that the bonds are taxable.

Two steps should be taken to reach this degree of certainty. First, you will need to forward your case to district counsel for their review to determine whether they would be willing to defend the case without further discovery. While hopefully litigation will not be necessary, this review ensures the certainty that we believe is necessary. In order to shorten district counsel review time and to prevent having to further develop the case after district counsel review, you should work with your district counsel while you are developing your case. Second, you will also need to send your case to the National Office for technical advice. Your technical advice request should be sent to the Office of the Assistant Chief Counsel (Financial Institutions & Products).

C. Forms 1099-INT

In addition to taxing the bondholders, the Service may also request that Form 1099-INT be sent to the bondholders, indicating that the interest they received on the bonds is taxable. Generally, the procedures for issuing statutory notices of deficiency that were discussed above, also apply when you plan on requesting that Form 1099-INT be sent to bondholders. You should indicate in your technical advice request that you anticipate requesting that Forms 1099-INT be sent.