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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index (UIL) No.: 141.01-07, 145.00-00
CASE MIS No.: TAM-111148-99/CC:DOM:FI&P:B5

OCT 22 1999

District Director
Southeast Key District

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Issuer =

Organization =

Bonds =

Facilities =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

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ISSUES:

This technical advice memorandum presents the following issues concerning the effect of a retroactive revocation of an organization's tax-exempt status under § 501(c)(3) of the Internal Revenue Code on the interest on bonds issued as § 501(c)(3) bonds under § 145 for the use of that organization:

(1) Whether the revocation of the Organization's § 501(c)(3) status causes the interest on the Bonds to be includable in the gross income of the Bondholders, and if so, is it includable retroactively to the date of issue of the bonds;

(2) whether the cancellation of the Bonds prevents interest on the Bonds from being includable in the gross income of the Bondholders; and

(3) whether the Issuer can challenge the revocation of the Organization's tax-exempt status administratively or judicially.

Should the responses to the above issues result in bond interest being includable in the Bondholders' gross income, the Issuer has requested relief under § 7805(b) that such result not have retroactive effect. This request will be addressed in a separate technical advice memorandum.

CONCLUSIONS:

(1) Interest on the Bonds is includable in the gross income of the Bondholders beginning with the date of issuance of the Bonds.

(2) Cancellation of the Bonds does not prevent interest on the Bonds from being includable in the gross income of the Bondholders.

(3) The Issuer can challenge whether the interest on the Bonds is includable in the gross income of the Bondholders through its right to an administrative appeal under Revenue Procedure 99-35, 1999-41 I.R.B. 501.

FACTS:

The Bonds were issued on Date 3, and the proceeds were loaned to a conduit borrower, the Organization, for purchase of the Facilities. The Organization had received a favorable determination letter as to its status as a tax-exempt organization under § 501(c)(3). The letter was dated Date 2 with an effective date retroactive to the Organization's date of incorporation, Date 1, which preceded Date 3. On or about Date 6, a determination letter was issued to the Organization revoking its status as a § 501(c)(3) organization retroactive to the taxable year ending Date 4, due to the deliberate action or actions of the Organization taken during that year. The exact date of those actions is not clear from the materials submitted. The issue date of the Bonds, Date 3, is within the Organization's taxable year ending Date 4. On Date 5,

which was more than 3 years after Date 4, the Bonds were canceled and taken off the market. The Organization did not pursue its administrative remedies for contesting the revocation.

LAW AND ANALYSIS:

Issue 1 - Includability of Bond Interest

Section 103(a) provides, with certain exceptions, that gross income does not include interest on any State or local bond. Section 103(b) provides that subsection (a) does not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(e) provides that the term "qualified bond" includes any private activity bond if such bond is a qualified § 501(c)(3) bond and meets other specified requirements.

Section 145 provides that a "qualified § 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property which is to be provided by the net proceeds of the issue is to be owned by a § 501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if--

a. § 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying § 513(a), and

b. paragraphs (1) and (2) of § 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

This case involves the effect on the Bonds of a determination that the conduit borrower's § 501(c)(3) status be revoked. The determination occurred several years after the Bonds were issued, but had an effective date retroactive to the taxable year in which the Bonds were issued. The issue of whether the revocation causes the interest on the Bonds to be includable in the Bondholders' gross income in part turns on the question of whether the tests under § 145 are to be applied only at the time of issuance of the Bonds or are applicable throughout the term of the Bonds.

The predecessor to § 145, § 103(b)(2) of the Internal Revenue Code of 1954 ("the 1954 Code"), was enacted by the Revenue and Expenditure Control Act of 1968, § 107, 1968-2 C.B. 715, 731. In enacting § 103(b)(2) of the 1954 Code, Congress intended that the subsidy inherent in tax-exempt bonds not benefit private

corporations. H.R. Conf. Rep. No. 1533, 90th Cong. 2d Sess., 32 (1968), 1968-2 C.B. 806; 114 Cong. Rec. 8147 (1968). Organizations described in § 501(c)(3) with respect to a trade or business that was not unrelated trade or business under § 513(a) were not considered as private corporations. § 103(b)(3) of the 1954 Code.

This intent to restrict the benefit of the subsidy was continued when Congress enacted § 145 in the Tax Reform Act of 1986, § 1301(b), 1986-3 C.B. (Vol. 1) 520, 546. At that time, Congress added the requirement that the property financed with qualified § 501(c)(3) bonds is to be owned by a § 501(c)(3) organization or a governmental unit. Id. The legislative history of § 145 clearly shows that Congress intended that the interest on § 501(c)(3) bonds only be excludable from the Bondholders' gross income where the proceeds actually are being used by a § 501(c)(3) organization in its exempt activities and the bond-financed facility is owned by such an organization or a governmental unit. H. R. Rep. No. 99-426, 99th Cong., 1st Sess., 537 (1985), 1986-3 C.B. (Vol. 2) 537; S. Rep. No. 99-313, 99th Cong., 2d Sess., 841 (1986), 1986-3 C.B. (Vol. 3) 841; H. R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., II-725 (1986), 1986-3 C.B. (Vol. 4) 725.

Accordingly, we consider the status of the Organization as the owner and user of the Facilities subsequent to the date of issuance of the Bonds. Actions of Organization caused its § 501(c)(3) status to be revoked. Therefore, the Facilities were no longer owned or used by a § 501(c)(3) organization, the Bonds were no longer qualified § 501(c)(3) bonds, and interest on the Bonds is includable in the Bondholders' gross income if a remedial action is either unavailable or ineffective. *Cf.* § 1.145-2(a) of the Income Tax Regulations (which provides that an issue ceases to be an issue of qualified § 501(c)(3) bonds if the issuer or the § 501(c)(3) organization takes a deliberate action, subsequent to the issue date, that causes the issue to fail to comply with the requirement of §§ 141(e) and 145 (such as an action that results in revocation of exempt status of the § 501(c)(3) organization)).

Having decided that interest on the Bonds may be includable in the Bondholders' gross income because of the revocation, the question remains as of what date would it be includable. Congress generally intended the interest to be includable retroactive to the date of issuance of the bonds. H. R. Rep. No. 99-426, 99th Cong., 1st Sess., 560 (1985), 1986-3 C.B. (Vol. 2) 560 ("Under present law, interest on bonds may become taxable, either retroactively to the date of issue or (if specifically provided in the Code) prospectively, if certain events occur."); see also, H. R. Rep. No. 99-426, 99th Cong., 1st Sess., 498, 553, 558 (1985), 1986-3 C.B. (Vol. 2) 498, 553, 558. Where Congress did not intend the inclusion of interest to be retroactive, it so provided. *Cf.* § 144(a)(4)(D). Section 145 contains no such provision. Consequently, the interest on the Bonds is includable, if at all, retroactively to the date of their issuance.

For the above discussion, we assume that the date of the action or actions causing the Organization to lose its § 501(c)(3) status occurred after the issuance of the Bonds. If the action or actions occurred on or before the date of issuance, the result would be the same because the Bonds would not have been qualified § 501(c)(3) bonds; further, the following remedial action discussion would be inapplicable.

Issue 2 - Cancellation of the Bonds

In this case, the tax-exempt status of the Organization was revoked effective with the Organization's taxable year ending Date 4, based on its deliberate action or actions during that taxable year. The Bonds were canceled on Date 5, more than 3 years after Date 4. This raises two questions. The first is whether in this case, cancellation of the Bonds is a "remedial action" that could prevent interest on the Bonds from being includable in the gross income of the Bondholders. Assuming that cancellation of the Bonds is a remedial action, the second question is what is the relevant date for evaluating whether the remedial action is effective to prevent interest on the Bonds from being includable in the gross income of the Bondholders.

Revenue Procedure 93-17, 1993-1 C.B. 50, sets forth conditions under which a change in use of bond proceeds from a qualified to a nonqualified use will not result in the bonds being treated as violating certain requirements of §§ 141 through 150. This revenue procedure is effective for any change of use of a bond-financed facility that occurs after March 8, 1993. Section 1.141-12, (made applicable to qualified § 501(c)(3) bonds by § 1.145-2(a)), generally effective for bonds issued after May 16, 1997, sets forth similar conditions under which an action that causes an issue to meet the private business tests is not treated as a deliberate action.

The effective date of Revenue Procedure 93-17 falls within the Organization's taxable year ending Date 4; however, the specific date of the action or actions of Organization causing the revocation of its § 501(c)(3) status (see discussion below) is uncertain. For purposes of this technical advice, we assume that neither Revenue Procedure 93-17 nor § 1.141-12 are applicable. Nevertheless, the principles underlying Revenue Procedure 93-17 and § 141-12 can be applied to these facts. Regardless, we would apply the same analysis and reach the same result under Revenue Procedure 93-17, because the facts in this case do not fit within the safe harbor that is presented there.

In Revenue Procedure 93-17, the tax-exempt status of the bond interest is preserved if the bonds that financed the facility are redeemed or defeased within 90 days after the change in use of the facility. The principle underlying this rule is that removal of the tax-exempt bonds from the marketplace ends the subsidy inherent in

the exemption, thereby preventing it from benefitting the nonqualified use. In this case, cancellation of the Bonds had the potential for achieving this same result and is a remedial action that, if properly taken, would prevent interest on the Bonds from being includable in the gross income of the Bondholders.

Consideration of whether or not cancellation of the Bonds was effective to prevent Bond interest from being includable in the gross income of the Bondholders requires a determination of when the action or actions occurred that caused the Bonds to be non-qualified. This in turn requires a determination of whether for measurement purposes it was the act of sending the revocation letter to the Organization or the Organization's action or actions causing the revocation that are relevant. Under § 1.145-2(a), the timeliness of an effective remedial action is measured from the action or actions of the § 501(c)(3) organization that caused the revocation. That organization is responsible for ensuring compliance with the requirements that entitle it to enjoy the benefits of a § 501(c)(3) organization. This principle is applicable in this case and leads us to conclude that it is the Organization's action or actions that are relevant for determining whether cancellation of the Bonds was an effective remedial action. Although this may place a hardship on issuers, this result ensures that the benefit of the subsidy inherent in tax-exempt bonds is restricted to the users intended by Congress.

Under Revenue Procedure 93-17, as well as § 1.145-2(a) (applying § 1.141-12), the remedial action of redemption or defeasance of non-qualified bonds must occur within 90 days of the action or actions that caused the bonds to be disqualified. Under such circumstances, the de minimus benefit to the non-qualified user of the bond-financed facility during that period is ignored. In this case, the Bonds were canceled more than 3 years after the action or actions of Organization that caused it to no longer qualify as a § 501(c)(3) organization. This amount of time is not de minimus and cannot be ignored. The cancellation of the Bonds, therefore, is not a proper remedial action because it was not timely taken. It does not prevent interest on the Bonds from being includable in the gross income of the Bondholders.

Issue 3 - Issuer's Right to Challenge Revocation

Section 7428 provides that an organization that exhausts its administrative remedies may seek a declaratory judgment regarding a determination revoking its qualification as an organization described in § 501(c)(3) by filing a pleading in the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia, before the 91st day after the date of the mailing of the adverse determination letter. Thus, the Issuer is not the appropriate petitioner for an action under § 7428.

Section 7478 provides that the prospective issuer of bonds may file an action for

a declaratory judgment in the Tax Court regarding an adverse determination as to the excludability of interest of the prospective obligations from gross income. Section 7478 applies only to prospective obligations, not outstanding obligations. The Bonds are not prospective obligations. Section 7478 provides the only avenue for the issuer to challenge the tax-exempt status of bonds in court, because it is the Bondholders, not the issuer, that bear the liability of the tax on the interest.

Accordingly, we conclude that the Issuer is unable to challenge in a judicial forum the revocation of the exempt status of the Organization or the includability of the interest on the Bonds.

Revenue Procedure 99-35, 1999-41 I.R.B. 501, provides procedures for issuers to request an administrative appeal to the Office of Appeals of a proposed adverse determination by an Employee Plans/Exempt Organizations Key District ("District") that the interest on their debt obligations is not excludable from gross income. Pursuant to Revenue Procedure 99-35, once the issuer receives a written notice from the District containing the proposed adverse determination, the issuer may request an appeal.

In this case, therefore, should the District issue a written notice containing a proposed adverse determination as to the excludability of the interest on the Bonds, at that time, the Issuer may follow the procedures in Revenue Procedure 99-35. Thus, although the Issuer cannot pursue a judicial challenge to the Organization's § 501(c)(3) status, it has available to it the administrative appeal process through which to challenge the includability of interest on the Bonds in the gross income of the Bondholders.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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