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Mr. Stone

Mr. Javaras

Advance Refunding of State and Local Tax Exempt Obligations

Mr. J.A. Burrows recently wrote the Secretary commenting upon the widespread practice of states and municipalities issuing tax exempt refunding obligations the proceeds of which are invested in United States government bonds bearing higher interest rates. Mr. Burrows asserts that this practice tends to increase the volume of outstanding tax exempt bonds. He also seems to contend that investment in securities, at least to the extent of trading on the tax exemption, is not a proper governmental function.

The refunding is accomplished in the following manner. A municipality has outstanding tax exempts which are not presently subject to call that were issued at a time when interest rates are higher. It would like to refund the outstanding bonds because of today's lower interest rates but is prevented from doing so by the provision in the indenture which prevents call of the outstanding bonds until some future date. Therefore, it issues refunding obligations approximating the face value of those outstanding and invests the proceeds in United States bonds bearing higher interest rates. The United States bonds, with maturity date approximating that of the first issue of tax exempts, are escrowed. The proceeds from the retirement of the United States bonds are restricted to use in refunding the first issue of tax exempt bonds, but the interest on the United States bonds secures the interest accruing on the refunding issue until the old bonds are refunded.

The vice of the transaction is that to a degree the municipality is really making a profit from transforming United States obligations, the interest on which is taxable in full, into tax exempt municipal obligations. If a municipality bought United States bonds, deposited them in an escrow, and issued an equivalent amount of tax exempt bonds with the same maturity date, the interest and principal to be paid from the escrowed United States bonds, it would be clear that the only function engaged in by the municipality was arbitraging its own bonds. Because of the exemption feature, and the high grade collateral, the municipality could always make a profit. In such a situation it would be relatively easy to tax the purchaser of the municipal bonds on the interest he received, notwithstanding section 103, on the ground that he has in fact invested in United States bonds. Admittedly the municipality may have pledged its full faith and credit for the payment of interest and the redemption of the bonds at maturity, but the escrow feature in addition to the immediate investment in the relatively riskless United States obligations maturing at approximately the same date would indicate that only United States bonds were purchased. The conclusion that the investor should be taxed on the interest in this situation is not affected by the Service's examination of the practice of advance refunding in 1963. The Service then concluded that section 103 constituted a bar to the taxation of the interest because the statutory exemption was phrased in absolute terms, but did not consider the practice of using escrows and possible sham theories.

Furthermore, there would seem to be a good ground for taxing the municipality on the interest from the United States bonds. Section 115 provides that "gross income does not include (1) income derived from any public utility or the exercise of any <u>essential</u> governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia..." [Emphasis added.] It would seem that arbitraging the tax exemption is not an essential governmental function. The Service's conclusion in 1963 that the interest on U.S. bonds is not taxable to the municipality would appear only to encompass the situation where the municipality invested surplus funds as an "essential governmental function." In this case the municipality is generating the funds to be invested by the same transaction, and pledging the funds received for the payment of the principal and interest of the obligations sold. It is hard to conceive that any rule that investment of surplus funds is a proper, and essential governmental function could encompass this situation.

While Mr. Burrow's letter is helpful in disclosing that the investments in United States bonds are escrowed and thus provide a possible handle for curtailing this abuse, the argument that the purchaser of the refunding bonds has in actuality purchased United States bonds is of more questionable validity in the normal advance refunding situation.

In the advance refunding case, the purchaser of the refunding bonds will claim that he has not primarily purchased United States bonds. Only the interest received on the United States obligations until the date the old municipals are refunded secures his claim to interest. For example, the issue of $197,000,000 of Public Utility District No. 1, Grant County, Washington bonds issued in 1963 had maturities ranging from 1988 through 2009, whereas the proceeds were to be invested in United States securities only until 1970, when the old bonds were to be refunded. Thus, a minimal share of the interest received was to secure payment of interest on the refunding bonds. Second, the claim of the refunding bond holders to payment of principal was in no way secured by United States obligations. The United States bonds are pledged for the refunding of the old municipals. Furthermore, they will assert that the refunding bonds were issued only because of favorable market conditions in the form of law interest rates. Surplus funds are generated only because the old municipals may not be called until some future date, and it would be unthinkable to deprive the municipality of interest during that relatively short period.

Our approach, taxing only the interest on the refunding bonds during the period that the proceeds are invested at interest, might have some chance of success in the courts on the theory that during that period the investor has in substance purchased United States bonds. Strong emphasis on the escrow as security for interest and an attempt to tax only the interest during the period that income is generated from investment of the proceeds would afford some chance of success.

It would appear that the issuance of a regulation or ruling to the effect that interest on the refunding bonds is taxable during the period the proceeds are invested would probably be the best approach for attempting to curtail the abuse, at present. Legislation is at best, a hazardous undertaking. Immediate issuance of a regulation or ruling on the other hand would limit the practice, at least until an adverse result in a test case, because of the normal caution exercised by investors and counsel for the municipalities, and in addition would bring the abuse to public attention.

If legislation is thought desirable, the Service prepared a draft bill in 1963, which could serve as the starting point of any present proposals.