

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224 June 1, 2000

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler

Assistant Chief Counsel CC:DOM:FS

SUBJECT: Definition of Refunding Issues

This Field Service Advice responds to your memorandum dated February 24, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Issuer =

Partnership 1 = Partnership 2 =

Project = City = Corporation = Bonds 1 =

Bonds 2 =

Date 1 = Date 2 =

Year 1	=
Year 2	=
<u>a</u>	=
<u>b</u>	=
<u>C</u>	=

ISSUE

Whether bonds issued in Year 2 are precluded from being treated as refunding bonds due to the reorganization in Year 1 of the conduit borrower under the prior bonds.

CONCLUSION

It is our opinion that the available information does not support an argument that the bonds issued in Year 2 are not a refunding issue solely because of the reorganization of the conduit borrower nearly 18 months prior to the issuance of the bonds.

FACTS

On Date 1, the Issuer issued its Bonds 1 in the principal amount of $\$\underline{a}$. Bonds 1 were issued on behalf of Partnership 1, a limited partnership, to be used to construct Project, a personal care facility for the elderly located in City.

On Date 2, Partnership 1 filed a petition for voluntary reorganization under Chapter 11 of the Bankruptcy Code. Partnership 1 operated and maintained Project as a debtor in possession during the bankruptcy proceeding. Partnership 1's plan of reorganization was subsequently confirmed in Year 1.

Under the plan of reorganization, Corporation replaced the former general partner of Partnership 1 and acquired a 10 percent ownership interest. The remaining 90 percent of Partnership 1 was acquired by two other unrelated corporations. Accordingly, in Year 1, Partnership 2 was formed.

In Year 2, Issuer issued its Bonds 2 in the principal amount of \$\(\frac{b}{0}\), \$\(\frac{c}{0}\) of which was used for refunding Bonds 1. Security for Bonds 2 consists of a loan agreement between Issuer and Partnership 2 and a mortgage on Project.

LAW AND ANALYSIS

Section 103(a) of the Internal Revenue Code provides that gross income does not include interest on certain State or local bonds. Section 149(d)(1) generally provides that nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in section 149(d)(3). For bonds originally issued before 1986, section 149(d)(3)(A) provides, in part, that an issue is described in section 149(d)(3) if any bond (issued as part of that issue) is issued to advance refund a bond unless the refunding bond is only the first or second advance refunding of the original bond.

Treas. Reg. § 1.150-1(a)(1) generally provides that the definitions in section 1.150-1 apply for all purposes of sections 103 and 141 through 150.¹ Treas. Reg. § 1.150-1(d)(1) generally defines "refunding issue" as an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue, including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue.

Treas. Reg. § 1.150-1(d)(2(ii)(A) provides that an issue is not a refunding issue to the extent that the "obligor" of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. Treas. Reg. § 1.150-1(d)(2(ii)(B) generally defines "obligor" as the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment.²

¹ Treas. Reg. § 1.150-1 applies to issues issued after June 30, 1993 to which Treas. Reg. §§ 1.148-1 through 1.148-11 apply. In addition, section 1.150-1(other than paragraph (c)(3)) applies to any issue to which the election described in Treas. Reg. § 1-11(b)(1) is made. Treas. Reg. § 1.148-11(b) provides that an issuer may apply the provisions of § 1.148-1 through § 1.148-11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954, in lieu of otherwise applicable regulations under those sections.

² Prior to the promulgation of Treas. Reg. § 1.1501-1, similar definitions of "refunding issue" and "obligor" were contained in former Treas. Reg. § 1.148-11(b).

In addition, Treas. Reg. § 1.150-1(d)(2)(v) generally provides that, if within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

Your memorandum requests advice as to whether the reorganization of Partnership 1 and formation of Partnership 2 in Year 1 precludes treatment of Bonds 2 as a qualified refunding of Bonds 1. Citing Treas. Reg. § 1.150-1(d)(2(ii)(A), the proposed position is that Bonds 2 is not a refunding issue because Bonds 2 and Bonds 1 have different obligors as a result of the change in Project's ownership. It is our opinion that the information provided does not support the proposed position.

First, there is no indication that the issuer elected to apply the provisions of Treas. Reg. § 1.150-1. As noted, that section generally applies to issues issued after June 30, 1993. Bonds 2 were issued several years prior to the effective date of the regulation. While an issuer may elect to apply the provisions of the regulation retroactively, it appears that the issuer in this case has expressly stated that the provisions of the regulation are inapplicable. Accordingly, as an initial matter, we recommend that you verify whether the issuer elected into any regulations subsequent to the issuance date of Bonds 2.

Further, even assuming the applicability of the cited regulations, it is our opinion that the proposed interpretation is overly broad. Under the suggested interpretation, an issuer would be unable to refund an obligation whenever there has been a change in ownership of bond-financed property. This overlooks the fact that a purchaser of bond-financed property may assume the obligations of the original conduit borrower. For example, the current regulations clearly recognize that a refunding may occur after a party assume obligations of an unrelated party in connection with an asset acquisition. Timing is the essential question. Treas. Reg. § 1.150-1(d)(2)(v) merely prohibits treating a refinanced issue as a refunded issue where the assumed issue is refinanced within six months before or after an asset acquisition.

In addition to the current regulations, the Service has long recognized the ability, or in some cases need, to substitute owners of bond financed property. For example, in Rev. Rul. 79-262, 1979-2 C.B. 33, the Service concluded that a corporation's purchase of industrial development bonds, substitution of itself as guarantor of the bonds and lessee of the financed facility, and resale of the bonds would not adversely affect the characterization of the interest on those bonds.

Based on the available information, we do not recommend asserting the position that Bonds 2 were not a refunding of Bonds 1 because of the change in ownership of the Project. Even assuming that Partnership 2 was a new entity after the bankruptcy reorganization, it apparently assumed the outstanding obligations at that time and became the obligor with respect to Bonds 1 approximately 18 months prior to the issuance of Bonds 2. Accordingly, the obligor on Bonds 2 was also the obligor on Bonds 1. This result is also consistent with the current regulations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

For the reasons discussed, we do not recommend pursuing the refunding issue raised in your request for advice.

Section 1001 governs for determining when securities received in exchange for securities surrendered in a transaction gives rise to a gain or loss. The standard, under Treas. Reg. § 1.1001-1(a) for determining whether an exchange of property is a disposition is whether the properties exchanged differ materially either in kind or extent.

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Other than the reorganization of Partnership 1 in Year 1, the current information does not support a reissuance argument. As stated, the mere change in the ownership of the conduit borrower has not been found to constitute a reissuance. See Rev. Rul. 79-262.

Please call if you have any further questions.

³ For alterations of the terms of a debt instrument on or after September 24, 1996, Treas. Reg. § 1.1001-3 addresses when a modification of a debt instrument is deemed to cause an exchange for purposes of section 1.1001-1(a) of the regulations. The provisions of this section may also be relied on for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

By: <u>Joel F. Helke</u>

JOEL E. HELKE Branch Chief Financial Institutions & Products