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MEMORANDUM FOR: District Counsel, Delaware-Maryland SER:DEM:BAL  
Attn: Clare Brooks

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Section 149(b) - Federal Guarantees

Internal Revenue Service National Office Field Service Advice

This Field Service Advice responds to your memorandum dated July 14, 1998. 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:

Authority

ISSUE:

What legal issues and facts should be considered in applying section 149(b)(4)(A) to exempt facility bonds, qualified small issue bonds and student loan bonds issued by the District of Columbia and U.S. possessions?

CONCLUSION:

Before we can provide any specific guidance on the Authority's bond issuance, we need additional facts. However, we can provide some general information on how to proceed with the audit of that case and other cases in the region. The key to determining whether the federal guarantee prohibition under section 149(b) is violated in the case of exempt facility bonds, qualified small issue bonds and qualified student loan bonds issued by U.S. possessions and the District of Columbia is to look to the source of payment of the debt service on the bonds. That includes looking at any guarantee or other indirect payments, not just who says they will pay the bonds. Are the bonds

obligations of the issuer, and because the issuer is an instrumentality of the United States, either directly or indirectly secured by the United States or are they revenue bonds secured solely by the revenues from the project? Generally, if they are revenue bonds secured by the project, then there would be no federal guarantee because the United States is not directly or indirectly the source of payment of debt service on the bonds. Even if payment on the debt service is not just solely from the revenues of the project, but also includes bond insurance or guarantees of a private borrower, that will not constitute a federal guarantee.

#### FACTS:

Southeast region has identified numerous exempt facility bonds or qualified small issue bonds issued by the . In particular, the agent was looking at the Authority's issuance. The agent has asked for guidance on how the Service should proceed in auditing these issues in light of section 149(b)(4)(A). No case specific facts were provided.

#### LAW AND ANALYSIS:

Section 149 (b)(1) provides that section 103 will not apply to any state or local bond that is federally guaranteed. Section 149(b)(2) sets forth what will constitute a federal guarantee.<sup>1</sup> Section 149(b)(2)(A) provides that a federal guarantee exists if the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency or **instrumentality** thereof). Section 149(b)(2)(C) is similar to (A) except that it provides that an indirect guarantee constitutes a federal guarantee.

Section 149(b)(4)(A) provides guidance on what entities constitute an instrumentality for federal guarantee purposes. That section provides:

**(A) Treatment of certain entities with authority to borrow from United States.**- To the extent provided in regulations prescribed by the Secretary, any entity with statutory authority to borrow from the United States shall be treated as an instrumentality of the United States. Except in the case of an exempt facility bond, a qualified small issue bond, and a qualified student loan bond, nothing in the preceding sentence shall be construed as treating the District of Columbia or any possession of the United States as an instrumentality of the United States.

Our reading of the statute is that the District of Columbia and U.S. possessions shall

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<sup>1</sup> The prohibition against federal guarantees was added to the Code in 1984 in former section 103(h). It was effective for obligations issued after December 31, 1983. The 1986 Act recodified section 103(h) of the 1954 Code as section 149(b) of the 1986 Code.

not be treated as an instrumentality of the United States for purposes of federal guarantees, unless they issue certain types of private activity bonds, i.e., exempt facility bonds, qualified small issue bonds and qualified student loan bonds. If the District of Columbia and U.S. possessions are considered to be instrumentalities for purposes of section 149(b), and they issue exempt facility bonds or qualified small issue bonds, does that mean that these bonds are automatically considered to violate section 149(b)? We conclude the answer is no. The fact that the bonds are issued by an instrumentality does not automatically mean that the bonds are federal guaranteed. Section 149(b) makes clear that to be a federal guarantee, payment of principal or interest of some or all of the bonds must be guaranteed directly or indirectly by the United States or its instrumentalities. If the debt service on the bonds is paid solely from the revenues of the project or other non issuer sources with no obligation on the part of the issuer, then under the definition of federal guarantee in section 149(b)(2), there is not a federal guarantee. If however, there is any payment obligation from the instrumentality, such as in the case of general obligation bonds, then the bonds would be federal guaranteed and would be taxable.

This reading of the statute is supported by the legislative history for the Deficit Reduction Act of 1984. The supplemental House Report states:

Finally, the bill provides that the District of Columbia or any U.S. possession (including Puerto Rico, the Virgin Islands and Guam) is not to be considered an instrumentality of the United States, under the rules pertaining to Federal statutory authority to borrow from the United States. However, this amendment does not apply in the case of private activity bonds (e.g., IDBs or student loan bonds). Thus, under the bill the District of Columbia or a U.S. possession having statutory authority to borrow from the U.S. may issue tax-exempt bonds other than private activity bonds subject to the same limitations (other than the rules pertaining to authority to borrow from the United States) which are applicable to obligations issued by States. In addition, the District of Columbia or a U.S. possession may issue private activity bonds if the bonds are not guaranteed by the governmental entity involved, determined under the general rules regarding Federally guaranteed obligations (e.g., revenue bonds backed by revenues from the financed project rather than revenues of the issuing government).

(Emphasis added). H.R. Rep. No. 432, 98<sup>th</sup> Cong., 2<sup>nd</sup> Sess., 1690-91 (1984). See also Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 941.

Prior to the 1984 Act, certain U.S. possessions, including Puerto Rico, Guam and the Virgin Islands were able to issue tax-exempt industrial development bonds as general obligation bonds or revenue bonds. See 48 U.S.C. secs. 745, 1403, 1423a. The District of Columbia was also able to issue general obligation bonds, and revenue bonds for certain purposes, including housing, health, transit and utility facilities, pollution control facilities, and industrial and commercial development. See D.C. Code,

secs. 47-332 and 47-334. However, after the 1984 Act, the legislative history specifically provided that provisions of the Internal Revenue Code relating to tax-exempt obligations are extended to bonds which are described in provisions of Federal law outside the Code. Specifically, any Code provisions relating to IDBs. See S. Prt. 169 at 700; H.R. Rep. No. 432 at 1693. Therefore, any private activity bonds issued by the District of Columbia and U.S. possessions must comply with the federal guarantee provisions, now under section 149(b). Therefore, if the District of Columbia were to issue general obligation bonds for exempt facilities, there would be a federal guarantee because the District of Columbia is an instrumentality of the United States. If revenue bonds are issued with no obligation or guarantee of the District of Columbia, there is no payment by the United States, directly or indirectly and hence no federal guarantee.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

For purposes of determining whether there is a federal guarantee problem for the cases in the Southeast region involving U.S. possessions and the District of Columbia, you need to determine the source of payment of debt service on the bonds. This information is key to determining whether there is a violation of the federal guarantee provisions. The bond transcript, particularly the official statement and the indenture will provide this information. It will have the source of payment on the debt service and would also indicate whether there were any other sources of guarantees or indirect payments.

Once you have developed further facts on the Authority's issuance, we will be glad to provide further assistance, if necessary. Finally, we want to remind you that any cases that the agent may preliminarily determine have a federal guarantee violation must come in for technical advice.

If you have any further questions, please call (202) 622-7870.

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BY: \_\_\_\_\_  
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