INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 14, 1999

Number: **200023002**
Release Date: 6/9/2000
Index (UIL) No.: 148.08-00
CASE MIS No.: TAM-113866-99/CC:DOM:FI&P:B5

   District Director:

   Taxpayer's Name:

   Taxpayer's Address:

   Years Involved:

   Date of Conference:

LEGEND:

<u>A</u>	=
Bonds	=
<u>V</u>	=
<u>W</u>	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=
<u>Q</u>	=
Date #1	=
Date #2	=
Date #3	=
Period #1	=

ISSUE:

On what date should A's late payment of rebate, paid for Period #1 (the first computation period), be taken into account for purposes of computing rebate for the final computation period?

CONCLUSION:

For purposes of computing rebate for the final computation period, A's late payment of rebate is taken into account as of the date the payment was due.

FACTS:

On Date #1, A issued the Bonds. Approximately, 9 ½ years later, on Date #2, A redeemed the Bonds. On or about Date #2, A discovered that it had failed to pay its rebate liability for the Period #1 (the first computation period). On Date #3, less than 180 days after discovering its unpaid rebate liability, A filed Form 8038-T, "Arbitrage Rebate and Penalty in Lieu of Rebate", indicating on the Form that it elected to apply §§ 1.148-1 through 1.148-11 of the Income Tax Regulations[1] to the Bonds. A made a payment in the amount of Z with the Form 8038-T. A also included a statement with Form 8038-T indicating that, although it was paying the rebate payment late, it was subject to § 1.148-3(h)(3) because the late payment was due to an innocent mistake, not willful neglect, and was paid within 180 days after discovering that the rebate amount had not been paid.

At the end of Period #1, 100% of the unpaid rebate amount was $W. This amount was used it as the basis for determining that $X of interest, calculated at the underpayment rate specified by § 6621 of the Internal Revenue Code, was due to be paid to the United States so that the Bonds would not be arbitrage bonds.[2]

In the statement that accompanied the Form 8038-T, A explained that it was paying $Z, which was $Y less than $V (the sum of W and interest at the underpayment rate). This was because at the end of the final computation period for the Bonds, after payment of the rebate amount for Period #1 plus interest, it was entitled to a refund of rebate in the amount $Y due to negative arbitrage during the final period. According to A, its payment of the rebate amount plus interest at the § 6621 rate extinguished its rebate liability as of the end of Period #1. The rebate amount paid for Period #1,

---

[1] All regulations cited in this letter refer to the 1993 regulations published as T.D. 8476, 1993-2 C.B. 13.

[2] Issuer acknowledged that it was required to pay interest on only 90% of the rebate amount due at the end of Period #1.

combined with negative arbitrage in the final computation period, resulted in an overpayment of rebate as of the end of the final period in the amount of $Y.   The amount of this refund was set off against the amount $V to reduce A's payment to $Z.

The District Director disputed the fact that A was entitled to a refund of rebate. The District Director asserted that the final rebate amount due from A should be calculated based on the actual date A paid its rebate, Date #3. Consequently, A should not receive a payment credit based on the assumption that the rebate amount for Period #1 was paid on time. According to the District Director, under § 1.148-3(h), A should pay: (1) interest at the underpayment rate based on the rebate amount due at the end Period #1, plus (2) the rebate amount for Period #1 future valued at the Bond yield to the actual payment date, less (3) the arbitrage for the final computation period. The District Director's calculations resulted in an additional rebate amount due from A.

LAW AND ANALYSIS:

Under § 103(a) of the Internal Revenue Code, gross income does not include interest on any state or local bond. However, under § 103(b), this does not apply to a bond that is an arbitrage bond within the meaning of § 148.

An "arbitrage bond" is defined in § 148(a) as any bond issued as part of an issue any portion of which is reasonably expected at the time of issuance of the bond to be used directly or indirectly (1) to acquire higher yielding investments or (2) to replace funds that were used directly or indirectly to acquire higher yielding investments.

Under § 148(f), a bond is treated as an arbitrage bond unless rebate is paid to the United States in a timely manner. The amount that must be paid is equal to the excess of the amount earned on all nonpurpose investments over the amount that would have been earned if the nonpurpose investments were invested a rate equal to the yield on the issue.

Section 148(f)(3) provides that, except to the extent provided by the Secretary, the amount that is required to be paid to the United States by the issuer shall be paid in installments which are due at least once every 5 years. Ninety percent of the amount described in § 148(f)(2) is required to be paid at each installment prior to the final installment, at which time 100% is due. Section 1.148-3(e)(2) provides that the final computation date is the date that an issue is discharged

Section 148(f)(7)(1) provides that in the case of an issue which would fail to meet the rebate requirements, the Secretary may treat such issue as meeting such requirements if, (1) the issue is not a private activity bond (other than a qualified 501(c)(3) bond), (2) the failure to pay rebate is not due to willful neglect, and (3) the issuer pays to the United States a penalty in an amount equal to the sum of 50% of the amount which was not paid, plus interest. Interest is payable at the underpayment rate

established by § 6621, on the portion of the amount which was not paid on the date required, for the period beginning on such date. The Secretary may waive all or any portion of the penalty required under this paragraph.

Section 1.148-3(f)(1) provides that the first rebate installment payment must be made not later than 5 years after the issue date. Subsequent rebate installment payments must be made not later than 5 years after the previous computation date for which an installment payment was made. Each installment payment must be in an amount that, when added to the future value, as of the computation date, of previous rebate payments made for the issue, equals at least 90 percent of the rebate amount as of that date.

Section 1.148-3(j), Example 1, illustrates that in computing rebate, the future value of the rebate amount from the previous period is taken into account in the subsequent period for purposes of determining whether 90 percent of the rebate amount has been paid as of the subsequent computation date. Example 1 also illustrates that a rebate payment is future valued at the bond yield for the same purpose.

Section 1.148-3(g) provides that, each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. Payments made within this 60-day period are treated as paid on the computation date to which it relates. A rebate payment is paid when it is filed with the Internal Revenue Service at the place or places designated by the Commissioner.

Section 1.148-3(h) provides that the failure to pay the correct rebate amount when required will cause the bonds to be arbitrage bonds unless the Commissioner determines that the failure was not caused by willful neglect and the issuer promptly pays the rebate amount plus a penalty equal to 50 percent of the rebate amount not paid when required to be paid. Interest on this amount accrues at the underpayment rate specified in § 6621 from the date the correct amount was due to the date ten days before it is actually paid. The penalty is automatically waived if the rebate amount that the issuer failed to pay plus interest is paid within 180 days of discovering the failure, unless the Commissioner determines that the failure was due to willful neglect or the bond issue is under examination during the period beginning on the date the failure first occurred and ending on the date 90 days after receipt of the rebate amount.

In this case, A failed to timely pay the rebate amount owed from Period #1. Within 180 days after discovering this fact, it paid 100% of its rebate liability at the end of Period #1, plus interest accrued at the underpayment rate under § 6621 during the period in question. The Bonds were not under examination while they were outstanding and there are no facts to indicate that A's failure to pay the rebate amount on time was due to willful neglect. Nevertheless, according to the District Director, the Bonds are arbitrage bonds because part of the payment on Date #3 should have been allocated to interest at the underpayment rate and part to additional interest at the Bond yield,

calculated on the unpaid rebate amount from the time it was owed until it was actually paid. As a result, after crediting <u>A</u>'s payment to the interest accruals, under the District Director's theory, only a portion of the rebate amount was paid within the 180 day period.

        We conclude that the District Director is incorrect. Because <u>A</u> paid the rebate amount due at the end of Period #1 plus interest within 180 days after discovering that the rebate amount was unpaid, it met its rebate obligation for that period. The payment is taken into account as of the date the rebate amount was due, extinguishing <u>A</u>'s rebate liability for Period #1. Nevertheless, the payment could not have been an expenditure of Bond proceeds for purposes § 1.148-6(d) until the actual payment on Date #3. We also conclude that it correctly future valued the rebate payment from the date it was due at the end of Period #1 and deducted that amount from the rebate amount owed on the final computation date.   Because <u>A</u> earned negative arbitrage during the final computation period, we conclude that <u>A</u> was entitled to a refund of $<u>Y</u> that could be set off against the amount due the United States under § 1.148-3(h).

CAVEAT

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