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DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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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: Federal Guarantees under I.R.C. § 149(b)

This Field Service Advice responds to your memorandum dated December 2, 1999. 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 =

State =  
Agency =

Date 1 =  
Notes =

Program =

## ISSUE

Whether funds received from an agency of the United States to finance a public project that are, in turn, pledged to pay debt service on municipal obligations create an indirect federal guarantee.

## CONCLUSION

From the information provided, it does not appear that the debt service on the obligations is guaranteed, either directly or indirectly, by the federal government. As the actual receipt of funds from the agency is conditional, there is no transfer of risk to the federal government in the event of default on the obligations.

## FACTS

Authority is a political subdivision of State. Authority was formed for the purpose of providing financing to local governments located in State ("the localities") for the construction of public works and the acquisition of necessary equipment.

Agency is an agency of the United States and was established by Congress to provide credit services to rural areas. Such services include providing long-term financing for eligible public projects.

On Date 1, Authority issued its Notes. The proceeds of the Notes are used to fund Program. Program provides interim loans to localities for certain public projects. Prior to making a loan under the Program, however, Authority requires borrowing localities to obtain a commitment for permanent financing from Agency. Authority will make an interim loan under the Program only after the locality has received a commitment letter from Agency. Agency commitments are based on federal funds already allocated and are not subject to future federal budget considerations. However, the commitment for permanent financing is apparently conditioned on the completion of the public project for which the financing was granted. Moreover, there is the possibility that Agency may rescind its permanent financing commitment. The circumstances in which the Agency may rescind, however, are unclear.

An interim loan made under the Program is equal to the amount of permanent financing received by the locality from Agency. The loan agreement between Authority and each locality participating in the Program requires the locality to transfer to the trustee for the Notes all rights in funds to be received pursuant to the permanent financing. The funds received pursuant to the

permanent financing are assigned to the trustee to pay principal and interest on the Notes.

Notes are secured by the funds pledged under the trust indenture, which primarily include loan payments received by Authority under the Program. The credit rating agency for the Notes stated that its rating is based on the strong liquidity provided by the pledge of proceeds from the permanent financing. The official statement states that the Notes are not direct or contingent obligations of Agency.

### 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(b)(1), however, provides that section 103(a) does not apply to a State or local bond that is federally guaranteed.

Section 149(b)(2) provides that a bond is federally guaranteed, if:

- (i) the payment of debt service on the bond is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof;
- (ii) 5 percent or more of the proceeds of the issue of which the bond is a part is to be used to make loans, the payment of which is to be guaranteed in whole or in part by the United States or any agency or instrumentality thereof, or is to be directly or indirectly invested in federally insured deposits or accounts; or
- (iii) the payment of debt service on the bond is otherwise indirectly guaranteed in whole or in part by the United States or any agency or instrumentality thereof.

The prohibition under section 149 applies not only to direct guarantees, but also in circumstances where an underlying arrangement may result in the federal government indirectly guaranteeing debt service on an obligation. Congress intended that the determination of whether a federal guarantee exists be based on the underlying economic substance of a transaction, taking into account all facts and circumstances. See H.R. Rep. No. 99-426, at 1013 (1985).

The legislative history to section 149 suggests that an indirect federal guarantee may arise where the federal government contracts to purchase the output of a bond-financed facility. Id. Similarly, where the federal government leases property there may be an indirect guarantee by the United States. A key

element in determining whether a prohibited guarantee exists is whether there is a transfer of risk to the federal government. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 939.

In the instant case, no facts have been developed that would evidence a direct guarantee by the federal government. The current question, rather, is whether the pledge of proceeds from the permanent financing to the payment of debt service on the Notes results in an indirect federal guarantee. The mere fact that federal funds are available to pay debt service on the Notes, however, does not necessarily result in an indirect guarantee. The more important question is whether the substance of the transaction results in a transfer of risk to the federal government in the event of a default on the Notes.

From the information provided, it does not appear that the Agency's permanent financing commitment results in an indirect guarantee. The availability of federal funds is subject to the completion of the public project for which financing was granted, rather than upon a default on the Notes. Further, there is also the possibility that Agency may rescind its permanent financing commitment. Even though Authority may condition approval of interim financing on a locality's receipt of permanent financing, there is still no transfer of risk to the federal government to pay debt service on the Notes in the event of a default. Finally, there is no indication that a default on the Notes will trigger an obligation by the federal government to make payments on the Notes.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The statute and regulations provide virtually no guidance as to what constitutes an indirect guarantee. Further, as the legislative history instructs, whether an indirect guarantee exists depends on the facts and circumstances of the particular transaction. [REDACTED]

[REDACTED]

[REDACTED] For instance, the legislative history specifically refers to solid waste disposal facilities where the federal government is under contract to purchase the output of the facilities. H.R. Rep. No. 99-426, at 1016 (1985).

[REDACTED]



Please call if you have any further questions.

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