Part I

Section 149(d)—Advance refundings.

Rev. Rul. 2003-78

ISSUE

Whether bonds are advance refunding bonds within the meaning of § 149(d)(5) of the Internal Revenue Code if the issuer loans proceeds of the bonds to a governmental unit, and within 90 days of the date the loan is made, but more than 90 days after the issue date of the bonds, the governmental unit uses the proceeds to redeem outstanding tax-exempt obligations of the governmental unit.

FACTS

Issuer X, a governmental unit, issues bonds (Bonds) to make loans to other governmental units to finance or refinance governmental projects of those units. X loans a portion of the proceeds of the Bonds to a governmental unit (the Borrower) that uses the proceeds to redeem tax-exempt bonds (Prior Bonds) issued by the Borrower. The Borrower is the obligor of the Prior Bonds within the meaning of § 1.150-1(d)(2)(ii)(B) of the Income Tax Regulations. The redemption of the Prior Bonds occurs within 90 days of the date the loan to the Borrower is made, but more than 90 days after the issue date of the Bonds.

LAW AND ANALYSIS

Section 103(a) provides that, except as otherwise provided, gross income does not include interest on any State or local bond. Section 103(b)(3) provides that this exclusion does not apply to any bond unless the bond meets the applicable requirements of § 149.

Section 149(d)(1) provides that nothing in § 103(a) or any other provision of the 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 paragraph (2), (3) or (4) of § 149(d). Section 149(d)(3) provides, in part, that an issue is described in paragraph (3) of § 149(d) if any bond issued as part of the issue is issued to advance refund a bond, unless the refunding bond is only (a) the first advance refunding of the original bond if the original bond is issued after 1985, or (b) the first or second advance refunding of the original bond if the original bond is issued before 1986. Section 149(d)(5) provides that a bond is treated as issued to advance refund another bond if it is issued more than 90 days before the redemption of the refunded bond. *See also* § 1.150-1(d)(3), (d)(4).

Pursuant to § 1.150-1(a)(1), except as otherwise provided, the definitions in § 1.150-1 apply for all purposes of §§ 103 and 141 through 150.

Section 1.150-1(d)(1) provides that a refunding issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue, including 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. An issue is not a refunding issue, however, 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. § 1.150-1(d)(2)(ii)(A).

In general, § 1.150-1(d)(2)(ii)(B) provides that the obligor of an issue means 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. Section 1.150-1(b) defines the term "conduit borrower" as the obligor on a purpose investment (as defined in § 1.148-1). For example, if an issuer invests proceeds in a purpose investment in the form of a loan, lease, installment sale obligation, or similar obligation to another entity and the obligor uses the proceeds to carry out the governmental purpose of the issue, the obligor is a conduit borrower. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in § 1.148-1) does not include the ultimate recipient of the loan (*e.g.*, the homeowner, the student). § 1.150-1(d)(2)(ii)(B).

Section 1.148-1(b) defines the terms "purpose investment" and "program investment". A purpose investment is an investment that is acquired to carry out the governmental purpose of an issue. A program investment is a purpose investment that is part of a governmental program in which, among other requirements, at least 95 percent (90 percent for qualified student loans under § 144(b)(1)(A)) of the cost of the purpose investments acquired under the program represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, persons who provide housing and related facilities, or any combination of the foregoing.

Section 1.150-1(b) defines the issue date of an issue as the first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. In reference to a bond, the issue date is the date on which the issuer receives the purchase price in exchange for that bond. In no event is the issue date earlier than the first day on which interest begins to accrue on the bond or bonds for Federal income tax purposes.

The proceeds of the Bonds loaned to the Borrower are used to pay principal, interest, or redemption price on another issue, the Prior Bonds. Thus, under the general definition of refunding issue contained in § 1.150-1(d)(1), the portion of the Bonds allocable to the loan to the Borrower constitutes a refunding issue. There is no change in obligor under § 1.150-1(d)(2)(ii) to alter this conclusion. The loan to the Borrower from proceeds of the Bonds is a purpose investment, and it is not a "similar program investment" within the meaning of § 1.150-1(d)(2)(ii)(B). Although the loans of proceeds of the Bonds may be program investments, loans to governmental units to finance or refinance their governmental projects are not similar to qualified mortgage loans or qualified student loans for purposes of § 1.150-1(d)(2)(ii)(B) because they are not loans made to natural persons not engaged in a trade or business (with respect to the loans). Thus, the Borrower is an obligor of the Bonds. The Borrower is also the obligor of the Prior Bonds. Accordingly, the portion of the Bonds allocable to the loan to the Borrower constitutes a refunding issue. Because the redemption date of the Prior Bonds is more than 90 days after the issue date of the Bonds, the portion of the Bonds allocable to the loan to the Borrower are advance refunding bonds within the meaning of § 149(d)(5).

HOLDING

The portion of the Bonds allocable to the loan to the Borrower are advance refunding bonds within the meaning of § 149(d)(5) if X loans proceeds of the Bonds to the Borrower, and within 90 days of the date the loan is made, but more than 90 days after the issue date of the Bonds, the Borrower uses the proceeds to redeem the Prior Bonds.

DRAFTING INFORMATION

The principal authors of this revenue ruling are David White and Rebecca Harrigal of the Office of the Associate Chief Counsel (Tax-exempt and Government Entities), Internal Revenue Service. For further information regarding this revenue ruling, contact David White on (202) 622-3980 (not a toll free call).